AUG 4 1986

Y4.En2/3:99-DD

99th Congress
2d Session

COMMITTEE PRINT

COMMITTEE
PRINT 99-DD

COMPLETED

RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES

ORIGINAL

A REPORT

FROM THE CHAIRMAN OF THE

SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE

U.S. HOUSE OF REPRESENTATIVES

JULY 1986

99th Congress
2d Session

COMMITTEE PRINT

COMMITTEE
PRINT 99-DD

RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES

A REPORT

FROM THE CHAIRMAN OF THE

SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE

U.S. HOUSE OF REPRESENTATIVES

JULY 1986

U.S. GOVERNMENT PRINTING OFFICE
60-535 O
WASHINGTON : 1986

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

COMMITTEE ON ENERGY AND COMMERCE

JOHN D. DINGELL, Michigan, *Chairman*

JAMES H. SCHEUER, New York
HENRY A. WAXMAN, California
TIMOTHY E. WIRTH, Colorado
PHILIP R. SHARP, Indiana
JAMES J. FLORIO, New Jersey
EDWARD J. MARKEY, Massachusetts
THOMAS A. LUKEN, Ohio
DOUG WALGREN, Pennsylvania
BARBARA A. MIKULSKI, Maryland
AL SWIFT, Washington
MICKEY LELAND, Texas
RICHARD C. SHELBY, Alabama
CARDISS COLLINS, Illinois
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
RON WYDEN, Oregon
RALPH M. HALL, Texas
DENNIS E. ECKART, Ohio
WAYNE DOWDY, Mississippi
BILL RICHARDSON, New Mexico
JIM SLATTERY, Kansas
GERRY SIKORSKI, Minnesota
JOHN BRYANT, Texas
JIM BATES, California

JAMES T. BROYHILL, North Carolina
NORMAN F. LENT, New York
EDWARD R. MADIGAN, Illinois
CARLOS J. MOORHEAD, California
MATTHEW J. RINALDO, New Jersey
WILLIAM E. DANNEMEYER, California
BOB WHITTAKER, Kansas
THOMAS J. TAUKE, Iowa
DON RITTER, Pennsylvania
DAN COATS, Indiana
THOMAS J. BLILEY, Jr., Virginia
JACK FIELDS, Texas
MICHAEL G. OXLEY, Ohio
HOWARD C. NIELSON, Utah
MICHAEL BILIRAKIS, Florida
DAN SCHAEFER, Colorado
FRED J. ECKERT, New York

Wm. Michael Kitzmiller, *Staff Director*
Thomas M. Ryan, *Chief Counsel*
Linda G. Stuntz, *Minority Counsel*

Subcommittee on Telecommunications, Consumer Protection, and Finance

TIMOTHY E. WIRTH, Colorado, *Chairman*

AL SWIFT, Washington
MICKEY LELAND, Texas
CARDISS COLLINS, Illinois
JOHN BRYANT, Texas
JIM BATES, California
THOMAS A. LUKEN, Ohio
MIKE SYNAR, Oklahoma
W.J. "BILLY" TAUZIN, Louisiana
WAYNE DOWDY, Mississippi
JIM SLATTERY, Kansas
JAMES H. SCHEUER, New York
HENRY A. WAXMAN, California
EDWARD J. MARKEY, Massachusetts
JOHN D. DINGELL, Michigan
(Ex Officio)

MATTHEW J. RINALDO, New Jersey
CARLOS J. MOORHEAD, California
THOMAS J. TAUKE, Iowa
DON RITTER, Pennsylvania
DAN COATS, Indiana
THOMAS J. BLILEY, Jr., Virginia
JACK FIELDS, Texas
MICHAEL G. OXLEY, Ohio
HOWARD C. NIELSON, Utah
JAMES T. BROYHILL, North Carolina
(Ex Officio)

Marc E. Lackritz, *Staff Director/Chief Counsel*
Jane W. D'Arista, *Chief Finance Economist*
Mary Jo G. Wetmore, *Legislative Staff Assistant*
Paul C. Smith, *Associate Minority Counsel*

LETTER OF TRANSMITTAL

[illegible]

NINETY-NINTH CONGRESS
U.S. House of Representatives

SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
WASHINGTON, DC 20515

[illegible]

Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
Rayburn House Office Building
Washington, D.C.

Dear Mr. Chairman:

I would like to request that the report on "Restructuring Financial Markets: The Major Policy Issues" be accepted as a Chairman's Report and published as a Committee Print.

This report, written by the majority staff of the Subcommittee, analyzes information and views on the role and objectives of U.S. financial structure and regulation in the past and present. It reflects 14 days of hearings, many months of staff research, innumerable meetings with outside experts, and a close working relationship with Chairman Florio's Subcommittee on Commerce, Transportation and Tourism due to its jurisdiction over insurance. The report is intended to provide a context for evaluation of the issues involved in financial restructuring, reflecting the belief that an understanding of these issues and a focus on fundamental public policy goals will be critical in developing the consensus needed for Congressional action.

This report was written by Jane W. D'Arista, Darina C. McKelvie and Mary Jo G. Wetmore, under the direction of the Subcommittee's former Chief Counsel and Staff Director, David K. Aylward, with assistance from Martha L. Cochran, Helen C. Wiederhorn, Thomas H. Larsen and Sheryl J. Wilkerson. Interns of the Subcommittee's staff who contributed to this document are Arlena Filipowicz, Caroline Dunn, Debbie Gottschalk, Shelly Martin, Donna Sieminski, and Laura Taylor.

The Subcommittee's majority staff is solely responsible for the contents of this report, and responsibility for the introduction is mine. It does not necessarily reflect the views of any of the Members and their staff, either majority or minority, although my colleagues have been enormously supportive of the Subcommittee's efforts in this area. Nor does it reflect the views of outside readers. However, the suggestions, comments and criticisms of Paul Nelson and Stephen J. Friedman in particular greatly improved the final product, and we are very grateful for their time and wisdom.

Thank you for your cooperation and assistance in this matter.

With best wishes,

Sincerely yours,

Tim Wirth

Timothy E. Wirth
Chairman

BLANK PAGE

CONTENTS

RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES

Page

- Introduction ... 1
- Executive Summary ... 7
- Summary ... 17

PART I: THE FRAMEWORK FOR FINANCIAL STRUCTURE AND REGULATION

Chapter 1: The Current Debate on Regulatory Policy

- Introduction ... 55
- The Issue of Financial Consolidation ... 56
- Reorganizing the Regulatory Framework ... 57
- Eliminating Special Treatment for Banks ... 59
- The Limits to Deregulation ... 60
- The Impact of Financial Structure and Regulation on Economic Activity ... 62

Chapter 2: Issues in the Evolution of Federal Regulation

- Introduction ... 67
- Commercial and Investment Banking in the United States ... 68
  - The road to securities legislation ... 69
  - The legislative response to the Great Crash ... 70
  - The Bank Holding Company Act ... 73
- The Emerging Trend Toward Financial Consolidation ... 77
- Current U.S. Developments ... 82
- An Alternative Model: The German Financial System ... 85
  - Introduction ... 85
  - Characteristics of the German financial system ... 86
  - Advantages and disadvantages of the universal system ... 87
  - Finance and corporate governance in the German system ... 88

Chapter 3: The Changing Financial Environment

- Introduction ... 91
- The Monetary and Fiscal Environment ... 92
- The Interaction of Macroeconomic and Financial Developments in the 1970's ... 93
- Technological Change ... 97
  - Impact on securities markets ... 97
  - Role in the development of international markets ... 99
  - Utilization by depository institutions ... 100
  - Implication for money markets ... 100
  - Policy issues ... 101
- The Internationalization of Financial Institutions and Markets ... 102
  - Evidence of internationalization ... 102
  - Macroeconomic repercussions of internationalization ... 103
- Changes in Demands for Financial Services ... 105

Chapter 4: Responses to Financial Restructuring

- Introduction ... 109
- Early Congressional Responses: 98th Congress, First Session ... 110
  - The moratorium bills ... 110
  - The Treasury proposal ... 111
  - The Capital Markets Commission bill ... 113
  - The Isaac bill ... 114
- The Legislative Stalemate: 98th Congress, Second Session ... 115
  - Senate bills ... 116
  - The House Banking Committee bills ... 117

Page

Chapter 4—Continued

The Legislative Stalemate—Continued

- The Wirth Moratorium/Capital Markets Commission bill 118
- The Energy and Commerce Subcommittee bill 119
- Legislative Action in the 98th Congress 120
- Comparison of the House and Senate bills 121

Legislative Initiatives in the 99th Congress 125
- The Financial Institutions Equity Act of 1985 126
- The Depository Institutions Acquisition Act 126

Industry Views and Responses 127
Summary and Conclusions 131

PART II: THE GOALS OF REGULATION

Introduction 137

Chapter 1: Access to Capital and Credit

Introduction and Summary 141
An Overview of the Federal Government's Role in Financial Markets 144
- Regulatory and structural policies 144
- Tax policies 147
- Government credit programs 148

The Effects of Interest Rate Deregulation on Credit Flows 149
- Macroeconomic effects 150
- Institutional effects: bank service charges and branch closings 151

Some Product and Structural Changes That Alter Financial Flows 157
- Brokered deposits 158
- Interest payments on insured transactions accounts 160
- Money market mutual funds, money market deposit accounts 161
- Nonbank banks 162

The Absence of Market Innovations to Facilitate Capital Formation 164
Summary of Policy Concerns 165

Chapter 2: Balancing Competition and Soundness: The Debate on Bank Deregulation

Introduction 169
Soundness Regulation and Competitive Restraints 171
Deregulation and Risk 175
Interdependence and Systemic Risk 179
Substituting Market Forces for Direct Regulation 182
Regulating in a Deregulated Environment 186
Managing Liquidity 190
- Changes in strategies for managing liquidity 192

A Summary of Policy Concerns 194

Chapter 3: Promoting Competition and the Impartiality of Credit Decisions

Introduction: Specialization and Diversity Versus Consolidation 197
Consolidation as an Impediment to Impartiality 203
Consolidation and Financial Stability: The Role of Banks 207
Conflicts of Interest 210
- Insurance companies 211
- Investment banks 213
- Banks and bank holding companies 217
- Pension funds 219

Cross-selling and Tying Financial Services 221
The Concentration of Financial Resources 224
- Institutional concentration 226
- Asset concentration 240
- Implications of a link between financial consolidation and concentration 243

Summary of Policy Concerns 245

Chapter 4: Preserving the Economic Functions of Financial Markets

Introduction: An Overview of Financial "Missions" 251
Capital Investment Trends in the United States 255

Page

Chapter 4—Continued

- Developments in U.S. Capital and Credit Markets 258
  - The impact of macroeconomic policy and interest rate ceilings 263
  - Short-term borrowing and variable interest rates 264
  - Declining liquidity and increased risk 265
  - Developments in the equity market 266
- Changes in the Structure and Economic Functions of Capital Markets 266
  - Discount brokerage 266
  - The role of institutional investors 269
  - The impact of mergers, takeovers, leveraged buyouts, and corporate stock repurchases 274
  - Innovative and derivative securities products 280
  - Mortgage-backed securities and the emerging market for securitized debt 285
- Summary of Policy Concerns 290

PART III: PROTECTING CUSTOMERS OF FINANCIAL INSTITUTIONS

- Introduction and Summary 295

Chapter 1: Regulation to Ensure Soundness and Fiduciary Standards

- Introduction: Objectives and Problems 297
- Differences in Regulatory Approaches 301
  - Securities market regulation 302
  - Depository institutions 302
  - Insurance companies 303
- The Proliferation of Regulatory Disparities 306
  - Limited purpose banks 306
  - Banks' securities activities 307
  - "Bank-like" activities of securities firms 313
  - Similarities between insurance and securities products 315
- Disparities Between State and Federal Regulation 317
  - Expanded state powers for depository institutions 319
  - Interstate banking 322
  - Limitations on debt and equity investments 322
  - Regulatory considerations 323
- Summary and Policy Concerns 325

Chapter 2: Investor Protection

- Introduction: The Role of Disclosure 327
- Disclosure Requirements for Depository Institutions 329
  - Proposals for greater disclosure by depository institutions 332
  - Concerns about extending disclosure to depository institutions 334
- The Implications of the Internationalization of Capital Markets for Investor Protection 337
  - Enforcement problems 339
  - Proposals for harmonizing regulatory systems 340

Chapter 3: Financial Guaranty Insurance Programs

- An Overview of Financial Guaranty Insurance Programs 345
  - Deposit insurance 345
  - The Securities Investor Protection Corporation 346
  - State insurance guaranty funds 346
  - The Pension Benefit Guaranty Corporation 347
- Erosion of the Rationale for Differences in Protection 348
- The Adequacy of Financial Guaranty Insurance Programs 350
  - The Securities Investor Protection Corporation 350
  - Deposit insurance 351
  - State insurance guaranty funds 356
  - Pension Benefit Guaranty Corporation 359
- The Conflicting Goals of Deregulation and Insurance Protection 361
- Proposals to Reconcile Deposit Insurance Protection and Market Discipline 363

Page

Chapter 3—Continued
  Proposals to Reconcile Deposit Insurance Protection and Market Discipline—Continued
    Reducing deposit insurance coverage 364
    Risk-related premiums 366
    Private deposit insurance programs 367
    Raising capital-to-asset ratios 367
  Summary of Policy Concerns 368

APPENDIXES

Appendix A: Credit Allocation in the 1970's 371
Appendix B: Some Effects of International Capital Flows on U.S. Credit Markets 377
Appendix C: Initiatives of the Subcommittee on Telecommunications, Consumer Protection and Finance 379
  Subcommittee hearings: 1981-83 379
  Subcommittee hearings: 1984 383
  Summary of activities in 1985 389
Appendix D: Reforming the Federal Deposit Insurance Programs 396
  Purposes and priorities of deposit insurance coverage 397
  Assessing government exposure and the adequacy of fund reserves 397
  The potential for abuse by institutions and depositors 398
  The allocative impact of deposit insurance on savings and credit flows 398

ILLUSTRATIONS

Figure 1.—Housing Starts 96
Figure 2.—Changes in the Stock of Private Residential Housing 96
Figure 3.—The Framework of Financial Regulation 300
Table 1.—Selected New Securities Issues 124
Table 2.—Banks' Current and Prospective Shares of Securities Issues 125
Table 3.—Some Regulatory and Structural Strategies Affecting Access to Credit and Capital 147
Table 4.—Comparison of Concentration Ratios of Major Financial Services Sectors 226
Table 5.—Concentration in the Securities Industry 228
Table 6.—Concentration Among Banks 231
Table 7.—Concentration Among Thrifts 233
Table 8.—Concentration Among Insurance Companies 235
Table 9.—Concentration Among Institutional Investors 237
Table 9a.—Summary Breakdown of 37 Largest Institutional Investors 238
Table 9b.—Sectoral Breakdown of 37 Largest Institutional Investors 239
Table 10.—National Income and Net Fixed Nonresidential Investment 255
Table 11.—Funds Raised in U.S. Financial Markets 259
Table 11a.—Percentage of Total Credit Absorbed by Various Sectors 260
Table 12.—Funds Supplied in U.S. Credit Markets 261
Table 12a.—Percentage of Total Funds Supplied by Various Sectors 262
Table 13.—Corporate Stock Issues—Common and Preferred 275
Table 13a.—Change in Corporate Stock Ownership 275
Table 14.—Increase in Stocks of U.S. Financial Assets for Selected Periods 372
Table 15.—Averages of Annual Ratios of Funds Raised by Selected Sectors to Total Funds Raised in U.S. Credit Markets and to GNP: In Percent, 1950-84 375
Table 16.—Funds Raised/Supplied in U.S. Credit Markets by Domestic and Foreign Sectors as a Percent of GNP 377
Chart A.—Established Market Participation Among Financial Institutions 200
Chart B.—Selected Diversified Financial Conglomerates 201

INTRODUCTION

(By Timothy E. Wirth)

Economic growth is crucial to our nation's future. And our financial markets must be able to raise the necessary capital to fuel this economic growth.

Finance, therefore, performs a special role in our economy differentiating it from other industries and economic sectors. Moreover, as history has amply demonstrated, our financial system is exceedingly fragile. Recent developments, including technological change, the internationalization of financial institutions and markets, macroeconomic developments and policies, and changes in the supply of, and demand for, financial products and services have all contributed to greater interdependence among all our financial institutions and markets. Shocks to one financial sector or market now reverberate almost instantaneously throughout the entire financial system and thus threaten our economic goals. In March, 1985, for example, the failure of an obscure government securities dealer in Florida immediately produced lines of depositors camped outside of state-insured savings and loans in Ohio and drove up the price of gold by $35.

Therefore at this time of increased interdependence and great inherent fragility of the financial system, public policy should be directed toward maintaining and enhancing public confidence in our financial markets, so that these markets can continue to raise the capital needed to fund long term economic growth.

The Committee on Energy and Commerce has a vital interest in developments affecting the structure and regulation of the financial services industry. The committee's jurisdictional responsibilities include directly overseeing the regulation of securities firms and nonfinancial industries engaged in interstate commerce that are major customers and beneficiaries of the financial services industry, and an indirect role with respect to the regulation of insurance companies that are under the jurisdiction of the individual States. As part of the overall effort to meet these responsibilities, the Committee's Subcommittee on Telecommunications, Consumer Protection, and Finance—which has jurisdiction over the securities laws and oversight responsibility to maintain investor confidence in the nation's capital markets—has undertaken a series of hearings to evaluate the need for a new framework for financial regulation in a rapidly changing environment, and to assess the roles that financial intermediaries should play in meeting the needs of the economy.

The Subcommittee began hearings on the future of financial markets in 1981, focusing on the role of long-term financial investment in promoting capital formation and economic growth and on the availability and cost of capital. It held five hearings on these and other issues relating to financial restructuring in 1983, three hearings on specific legislative proposals in 1984 and three hearings in 1985 on developments in financial markets resulting from changes in financial structure and regulation.[1] Some of these issues were also discussed in oversight hearings on the activities of the Securities and Exchange Commission and in hearings on the secondary mortgage market, corporate takeovers, the role of pension funds in the capital markets, proposals for regulating the government securities market, and the recent dramatic expansion of U.S. public and private debt.

These hearings and the various bills I introduced that were cosponsored by other Members of the Subcommittee [2] were an outgrowth of our concern that the debate on financial restructuring had been dominated by conflicting claims of intermediaries for increased competitive opportunity and equity within the financial services industry (the so-called "level playing field"), that the resulting "costs" to those who invest and those who raise funds through financial intermediaries were less frequently discussed, and that these and other economic implications of financial restructuring had been generally ignored, as had the concerns and needs of the various economic sectors—small and large businesses, consumers, farmers, non-profit organizations and state and local governments.

The Subcommittee's efforts during this period also reflected concern that as the pace of restructuring accelerates, there is serious danger that the objectives of regulatory policy could be abandoned along with the framework in which they are currently embodied, since the existing regulatory framework no longer reflects coherent policy objectives. Concern arose that a new system could emerge that would fail to balance newer concerns for competition and efficiency against traditional concerns for safety and soundness, investor protection, the fairness and equity of access to capital and credit, and the prevention of conflicts of interest and concentration of financial resources. The argument that these traditional concerns, which were the basis for passage of the Glass-Steagall Act, the Securities Acts and other Depression-era financial legislation, can now be ignored because of improvements in the regulatory environment neglects the fact that these Acts were largely responsible for that improvement. A reexamination of the validity of these concerns is needed to establish the context for Congressional actions to modify the existing framework.

Several years ago, I proposed that such an analysis be undertaken by a Congressional commission composed of representatives of the financial services industry, the business and agricultural sectors, labor, consumers, state and local governments, academics and others with acknowledged expertise.[3] While this proposal was not adopted, widespread support for such an approach encouraged the Subcommittee to focus on the broader questions raised by changes in financial structure and regulation, and to report on the information and arguments developed in the hearing record. The major thrust of the Subcommittee's efforts in this area over the last five years was aptly summarized by Rep. Thomas Tauke in May 1984:

---

[1] Appendix C describes the issues and witnesses involved in these hearings.

[2] These bills were: H.R. 3397, to establish a Commission on Capital Markets to work closely with Congress in evaluating the economic impact of changes in financial structure and regulation, first introduced in 1982 and reintroduced with 71 cosponsors on June 22, 1983; H.R. 5342, to impose a short-term moratorium on further mergers of securities, banking and insurance institutions and combinations of their functions, introduced April 3, 1984 and cosponsored by Energy and Commerce Committee Chairman John Dingell and seven Subcommittee Members, and H.R. 5881, to close loopholes in current law and restrict their further exploitation by financial institutions and Federal and state regulators, introduced June 15, 1984 with Chairman Dingell and other Subcommittee Members as cosponsors. The bills and the actions taken by the Subcommittee are discussed in Part I, Chapter 4 of this report.

> What I think we are trying to do is assess what kind of impact the structure of these financial institutions and the structure of this regulatory scheme will have on the flow of capital to consumers and what impact does it have on the stability of our economy as a whole. That is the larger question.[4]

This report, therefore, is intended to provide a broader focus for the current debate by examining changes in financial regulation and structure from a public policy perspective. Drawing on the materials developed in Subcommittee hearings, the report discusses the special role and importance of financial intermediaries in the economy, the impact of financial restructuring on the viability of traditional public policy objectives and the current regulatory framework, and concerns about the soundness and viability of the financial system itself.

OUTLINE OF THE REPORT

The first section of this report contains a discussion of the current trend toward deregulation in the financial services industry in the context of present and past debates on the appropriate role for regulation and the influence of financial regulation and structure on economic growth. This section examines the rationale for the existing regulatory framework from an historical perspective. It also compares our regulatory framework to other major industrial countries, describes actual and proposed changes in the structure and regulation of financial institutions, and outlines the extent of the federal government's involvement in financial markets and its implications for financial deregulation compared to deregulation of other industries.

Part I also analyzes some of the factors that have contributed to changes in the structure of financial markets and their impact on the regulatory framework, including macroeconomic developments and policies, technological change, the internationalization of financial institutions and markets and changes in the supply of, and demand for, financial products and services. Finally, it surveys the responses to restructuring from the various sectors of the financial services industry, the regulators and others, and analyzes the various proposals that have been considered by Congress.

---

[3] See footnote 2. See also Part I, Chapter 4 for further discussion of the Capital Markets Commission proposal.

[4] *Financial Restructuring: The Road Ahead*, hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 2nd Sess., May 17, 1984, p. 564.

Part II of the report deals with the goals or objectives that have provided the rationale for laws governing financial regulation in the past: providing fair access to capital and credit, balancing competition and soundness within the financial system, assuring a diversity of sources of capital and credit by preventing conflicts of interest and the concentration of financial resources, and maintaining viable capital and credit markets to promote capital formation needed for economic growth. This section discusses perceptions of threats to these goals that may result from changes in financial structure, and suggests some of the policy concerns, including impaired economic growth or other significant social costs, that may result from these threats.

The choice of the traditional policy goals as a framework for this section reflects a necessary constraint. Regulation and deregulation are not goals per se. The acknowledged goals of those who advocate a greater degree of deregulation—increased competition, efficiency, convenience—are themselves traditional goals, firmly embedded in the existing legal and regulatory framework. But these goals, alone, are too narrow. We must raise our sights to focus on the broader implications of this debate to ensure that the resulting financial structure promotes long term economic growth.

Part III of the report discusses and compares the various regulatory strategies developed to protect customers of financial institutions—soundness regulation, disclosure and other mechanisms for protecting investors and the various insurance guaranty systems that constitute the financial safety net. Again, the focus is on perceptions of threats to these strategies that may result from changes in financial structure and regulation, as well as current perceptions about the soundness of the financial system.

The institutional focus of the report is necessarily selective. Much attention is given to the securities industry because the separation of commercial banking and securities activities has been a key issue in the debate on financial restructuring for most of this century. Moreover, the recent rapid expansion of securities markets and increase in trading activity is one of the more significant consequences of the deregulation of interest rate ceilings on bank and thrift deposits.

This report also gives substantial attention to banking issues because those issues are now, as in the past, at center stage in the debate, and because banking laws and regulations have borne the primary burden historically for defining U.S. financial structure. Less attention is given to the insurance industry than perhaps is warranted by virtue of its increased importance in the U.S. financial system in the post-World War II period. However, the United States is the only developed country that does not regulate this industry at the national level. Structural and regulatory issues involving insurance may well be widely discussed at the Federal level in the future, but that has not been the case so far.

This report offers few specific recommendations for policy actions. Instead it is intended to focus the debate on the nature of the public policy goals that can or should be achieved as a result of institutional and regulatory restructuring—to raise questions rather than provide answers. The report does suggest that the term "deregulation" as applied to the financial services industry is a misnomer. Compared with other industries, opportunities for deregulation are limited because of the current pervasiveness of, and need for, government involvement and intervention in financial markets and the industry's strong commitment to the rule of law and regulation in preserving a competitive environment, and because of this industry's unique role in funding economic growth.

BLANK PAGE

EXECUTIVE SUMMARY

The current levels of change, instability and risk in U.S. capital and credit markets underscore the need for a comprehensive evaluation of the structure and regulation of financial institutions. Because the financial system has public as well as private functions and responsibilities, these issues are an integral part of national economic policy to ensure long-term, stable economic growth.

> Financial institutions assume quasi-public responsibilities in facilitating economic transactions and channeling other people's money into productive investment. Because financial structure and regulation are critical factors in determining how savings are allocated, they affect the type and level of investment, the rate of economic growth, job creation, productivity, U.S. international competitiveness and standards of living.
>
> The financial system serves as the conduit through which monetary policy influences the economy. The effectiveness of monetary policy in stabilizing the economy depends on the stability, integrity and soundness of financial institutions and markets.
>
> Financial intermediaries are also inherently fragile. Even sound institutions may fail if the loss of public confidence in a single, unsound institution leads to a mass rush to liquidate assets. When the failure of a small, unregulated government securities dealer in Florida can send shock waves extending from the State of Ohio into money and currency markets around the globe, it is time to recognize that reshaping our financial system is a responsibility of government, not just markets.

Financial restructuring is already well underway. Both the kinds of changes that have already occurred and those advocated in some recent legislative proposals are a radical departure from U.S. historical experience. But the public policy debate so far has been dominated by inter-industry squabbling over shares of the financial services pie. The implications of the breakdown of the framework established by Congress 50 years ago largely have been ignored.

Thus, the purpose of this report is to focus the debate on the public policy concerns that have shaped decisions about financial structure and regulation in the past and on how changes in the financial system affect traditional regulatory objectives and our national economic policy goals.

The special nature of the financial services industry is clearly reflected in the history of the major laws and decisions that provide the framework for U.S. financial structure and regulation. Awareness of their special nature led to an astonishing variety of regulatory strategies designed to promote the economic functions of financial intermediaries, and to minimize risk and the economic disruptions that result from financial failures. These strategies have been embedded in a structural framework that segregated financial sectors, functions and products, and have been implemented through a regulatory framework reflecting those distinctions. This organizational framework was intended to accomplish certain specific public policy objectives:

to ensure access to capital and credit by providing a balanced distribution of savings and investment flows; by articulating the individual "missions" of financial sectors—e.g., providing working capital for businesses (banks) and loans to consumers (banks and credit unions); financing capital formation (securities firms, insurance companies and money managers) and housing (thrifts), and assuming risk for both individuals and businesses (insurance companies)—and by providing regulatory and competitive environments that reflected differences in financing requirements and, thus, differences in the kinds of risk faced by institutions and their customers;

to balance competition and soundness, taking into account the continuum between the private, entrepreneurial character of financial institutions and their quasi-public functions; balancing the propensity to take risks to assure gains for owners and customers in order to survive in a competitive marketplace against the need to assure soundness by containing excessive risk;

to enhance the efficiency of the market system by preventing conflicts of interest and the concentration of financial resources, thus ensuring that capital and credit decisions are impartial, and that there are numerous financial decision-makers with diverse points of view;

to ensure that the financial system exercises its fiduciary responsibility in maintaining the value of financial investment by channeling funds into productive uses and thus *functioning as a dynamic catalyst in promoting economic growth;* and

to protect customers by ensuring the integrity of institutions and markets and by cushioning the impact of failures.

These regulatory objectives are still valid. But the organizational framework through which they were implemented is disappearing—the result of an evolutionary process that began in the 1960s with:

wider use of the holding company structure by banks and insurance companies, the shift by major securities firms from partnerships to public companies and the expansion of international operations. Using these new structures, financial intermediaries are extending the range of their activities and are finding themselves competing with both financial and nonfinancial companies outside their traditional lines of business. These developments are changing the competitive environment and resulting in a proliferation of regulatory (and, thus, competitive) inequities that increase pressure for a further expansion of the range of activities of individual institutions and sectors;

changes in the macroeconomic environment—especially inflation, which pushed up nominal interest rates in the 1970s and increased investors' demand for short-term financial instruments paying market rates of interest. This, too, changed the competitive environment, forcing different sectors to compete in the same markets for funds and leading to the expansion of money market instruments—i.e., large negotiable certificates of deposit, commercial paper, repurchase agreements, and Eurodollar deposits—and to such innovations as money market mutual funds and money brokerage; and

innovations in information and communications technologies that integrated markets previously separated by geography and differences in regulatory treatment, and facilitated the development of new financial products and services that no longer fit into traditional categories.

As the barriers between financial sectors, functions and products fell, regulatory strategies that depended on a segregated structure became less effective or even counterproductive. In some areas, regulations have been relaxed, in others, evaded—without a clear understanding of the outcome overall.

Interest rate deregulation is a dramatic example of the way that the current ad hoc, piecemeal process of financial restructuring has led to consequences that threaten the stability of both the financial system and the economy. While certainly unintended, the decision to permit depository institutions to pay market rates of interest on short-term *insured* financial assets constitutes a unique experiment in the history of this or any other financial system.

It has perpetuated the imbalance in credit flows generated by the inflationary experience of the 1970s—the shift from long- to short-term financial investment—by institutionalizing the erosion of the risk-reward incentive that, in the past, made long-term assets attractive to investors.

It has made it more difficult for banks and thrifts to intermediate between the short-term preferences of depositors and the longer-term preferences of borrowers. This has encouraged institutions to develop strategies that limit interest rate risk (i.e., variable rate lending) but tend to increase credit risk.

It also precipitated the shift of a larger share of financing for housing from depository institutions to the capital markets where, backed by government guarantees and private insurance, mortgage-backed securities have combined with Federal budget deficits to crowd out corporate borrowers. The advent of newer forms of securitized credit—car loans and bank loans—will augment this trend by adding to the supply of short- and medium-term issues in capital markets.

It requires that depository institutions join with other intermediaries in devising new methods to hedge against a more volatile interest rate environment. The proliferation of derivative instruments (i.e., financial futures, options and index products) increases the amount of speculative activity needed to accommodate hedgers, expanding the volume and pace of activity in securities markets without augmenting their role in financing productive investment.

Thus, interest rate deregulation has directly and indirectly shifted the capital markets away from their primary function in financing capital formation—a result that has important consequences for job creation, productivity, U.S. international competitiveness, trade balances and economic growth prospects.

As the competitive environment has intensified, changes in the strategies, products and functions of financial institutions and sectors have tended to focus on gathering funds—an objective that primarily benefits the intermediaries themselves and the more affluent depositors and investors whose funds they seek—rather than on ways to ensure that funds are productively employed. The consequences of these developments for financial institutions and their customers are equally profound.

Consumers continue to pay exorbitant real rates of interest on credit cards; most also pay higher fees for traditional depository services, and some have lost access to these services altogether.

Consumer credit has risen to historic levels, fueling a U.S. recovery but contributing to the ability of the U.S. economy to absorb imports and worsening the U.S. trade deficit.

Despite developments that have reduced transactions costs, there has been a sharp decline in individuals' holdings of equities and in the maturity of institutional holdings of corporate bonds. The greatest increase in investment has been in government securities and new products (securitized credit and money market and derivative instruments) rather than traditional long-term assets that finance capital formation.

These developments have contributed to a deterioration in the aggregate balance sheet of the business sector by pushing up the ratio of debt to equity and lowering the maturity of debt. The result is less liquidity and increased vulnerability to changes in interest rates and the business cycle.

And the position of financial intermediaries mirrors these trends. They, too, are highly leveraged by historical standards and faced with the risks posed by a deterioration in credit quality that has resulted from the upward surge in debt and the downward pressure on its maturity.

Meanwhile, the blurring of distinctions between functions and products has already reshaped the financial system in ways that have important implications for the effectiveness of regulation.

Essentially similar services are regulated in very different ways with varying degrees of protection for customers. In many cases, this is because the applicability of regulation is based on industry labels rather than on functions and products; in others, because functions and products overlap and are difficult to define. And the problem is compounded by the fact that regulatory jurisdiction is currently exercised by 10 Federal agencies, more than one agency in each of the 50 states and over 20 self-regulatory organizations.

Trading activity has increased in both volume and importance, involving a wider group of participants (including depository institutions), and resulting in a greater degree of interdependence between financial institutions and markets at home and abroad that enhances the risk of systemic crises.

But much of the expansion in trading activity is conducted in uncentralized markets (for government securities, mortgage-backed securities, money market instruments and foreign exchange) not subject to monitoring, surveillance or direct examination. These gaps in regulation enable weaker institutions in all sectors to attract funds—particularly depository institutions that can exploit their insured status to shift risk to the deposit insurance funds.

In short, many of the new strategies devised to cope with a higher level of instability and risk in credit markets may now enhance the destabilizing effects they were devised to offset. And their tendency to move institutions and markets away from their traditional economic functions may result in a different kind of risk for financial intermediaries and the economy—a deterioration in credit quality—that may pose a greater danger than that which these new strategies were intended to protect against.

These regulatory problems will increase as the trend toward consolidating different products and functions in single financial conglomerates accelerates. There are already at least 26 major conglomerates (15 owned by commercial companies) providing more than one major financial service (banking, securities or insurance) on a nationwide basis, and many more operating in regional or local markets. The behavior of such conglomerates differs from that of independent institutions in ways that can increase, rather than reduce, risk.

The ability to cross-sell and integrate products and services can lead to a relaxation of credit standards because the goal is to maximize the profits of the company as a whole rather than preserve the viability of affiliates. But losses sustained by any affiliate will weaken the parent company and other affiliates, and may affect the availability or cost of raising capital.

Integrating functions and products may require a different (and perhaps higher) level of managerial skills. But those skills may subordinate fiduciary responsibility to the imperatives of efficiency and market survival. More of the risk may be shifted to customers, and may result in more defaults and greater losses to investors.

Consolidating financial functions and products may also tend to undermine the market system itself.

Integrating activities within a single holding company will reduce diversity and the independence of decisions involving individual financial functions and products.

It will also undermine the impartiality of capital and credit decisions because regulatory strategies to prevent conflicts of interest and tie-ins, or to monitor intracompany transactions, either do not exist or—as in the case of banks—as a practical matter, cannot be policed.

Because much of the consolidation that has occurred is the result of mergers, a continuation of this trend will reduce the number of decision-makers and increase the concentration of financial resources.

Concerns about excessive concentration and a contraction in the number of decision-makers in financial markets have begun to surface again with increased frequency.

Banks point to the high level of concentration in the securities industry and propose that they be allowed to underwrite corporate securities and municipal revenue bonds to increase competition.

The relaxation of restrictions on interstate banking has been structured by the individual states to prohibit or slow the expansion of money center banks to prevent their gaining a dominant role in regional and local markets, while encouraging the expansion of large, local banks.

Many corporate managers believe that a handful of institutional investors that control a sizable share of a company's stock can exert considerable pressure on management to adopt short-term performance objectives to accommodate these investors' own short-term performance objectives; and that this has contributed to a climate that has encouraged a proliferation of mergers, hostile takeovers, leveraged buy-outs and stock retirements.

There is some validity to these concerns. The U.S. financial system is already highly concentrated:

In each major sector, a very small number of institutions account for half of that sector's activity and resources—e.g., less than one percent of the total number of firms in the securities, banking and life insurance industries; about two percent of the total number of property-casualty insurers and a little more than four percent of all thrifts.

The financial services industry as a whole is dominated by the 10 largest bank holding companies whose assets ($724 billion or 25 percent of all banking assets) are greater than those of all life insurers, almost three times the assets of all property-casualty insurers, and only about 25 percent less than the assets of all thrifts. Their market power is significantly augmented by their extensive involvement in underwriting and dealing in securities and in managing $247 billion of assets for beneficiaries. Altogether, they control almost $1 trillion of assets—an amount equal to about 14 percent of total outstanding debt—and thus have a disproportionately large voice in making decisions about the allocation of financial resources.

Institutional investors (i.e., insurance companies, mutual funds, banks and other investment advisers that manage pension plans and other funds for beneficiaries) are now the dominant actors in securities markets. They own 35 percent of outstanding U.S. corporate stocks, 78 percent of U.S. corporate and U.S.-issued foreign bonds, 44 percent of all Treasury debt and account for over 70 percent of all trading on the New York Stock Exchange. Only thirty-seven institutions account for half of the approximately $2.4 trillion of assets controlled by this group.

The holdings of institutional investors are highly concentrated as well. Institutional ownership of the outstanding shares of some large companies is as high as 60 to 80 percent. The absence of restraints on their aggregate investments in individual companies enhances the role of money managers in corporate governance, in deciding the outcome of takeover battles, and in choosing winners and losers in the competition for corporate financing.

Even if size itself were not a problem, the reduction in the number of decision-makers (and, thus, the number of individual outcomes) makes the individual decisions and outcomes of these actors very important, whereas the underlying assumption of a free market economy is that the multiplicity of actors makes the decisions or failures of one actor irrelevant. But size is a problem. Current levels of concentration threaten the adequacy of financial guaranty programs—i.e., deposit insurance, the Securities Investor Protection Corporation (SIPC), and state guaranty funds for the insurance industry—and it is now widely recognized that deregulation also poses a significant threat to these programs. The rising level of insolvent or illiquid institutions raises questions about the extent of governments' (and taxpayers') overall exposure as the ultimate guarantors of the insured funds of their customers, and raises a number of other new issues and concerns:

> Insurance programs may be counterproductive in promoting stability in an increasingly deregulated financial environment if institutions can "afford" to take greater risks because the same level of protection is provided at the same cost for customers of both "risky" and "safe" institutions.
>
> Continuing to insure financial functions that are integrated with uninsured or less insured functions may increase the risk to insurance programs and erode public confidence in the financial system.
>
> Changes in the functions of various intermediaries and sectors may have undermined the rationale for differences in insurance protection.
>
> There is pressure on regulatory agencies to relax, rather than improve, regulatory standards as competitive advantages are increasingly determined by regulatory classifications rather than the merits of particular products and services.
>
> Differences between Federal and state standards for permissible activities are now so extensive in some cases that both the rationale for continuing to provide insurance protection at the Federal level and the rationale for preserving the dual (Federal and State) regulatory system are being seriously questioned.
>
> Given the current level of risk and the integration of financial and nonfinancial activities, it is increasingly difficult to justify denying investors and customers the benefits of full disclosure about the financial condition of intermediaries. But given the nature of financial, especially depository assets—their susceptibility to immediate liquidation—disclosure, in the past, was not seen as applicable to depository institutions—only to commercial enterprises. The "discipline" that disclosure imposes and the skepticism that it evokes can result in widespread loss of confidence that may well increase the number of failures and losses to customers.
>
> The free market requires downside, as well as upside, risk, but the number of "too big to fail" institutions will increase as the integration of functions and products proceeds and geographic restrictions on depository institutions are relaxed, setting up a significant, and ironic, tension between deregulation and government protection.

The consensus view is that instability in the financial system and risk to the financial guaranty programs will increase if no action is taken. But views on how to reduce instability and risk remain highly polarized:

Some argue that partial deregulation has eroded profits, particularly for banks, and that additional deregulation—e.g., increased competitive opportunities resulting from an expansion of permissible activities—will augment profits and lower the aggregate level of risk.

Others doubt that further deregulation will increase profits without augmenting instability and risk. They advocate limiting permissible activities and improving soundness regulation.

In the middle are those who believe that deregulation has created problems that require a fundamental reexamination of differences in financial functions and regulatory schemes; that what is needed is neither less nor more regulation, but more *appropriate* regulation.

The weight of the evidence presented in this report suggests that a major agenda for regulatory reform has emerged that requires immediate attention; "reforms" that merely shift responsibilities from one regulator to another will accomplish very little. There is clearly the need to address:

questions about the adequacy of financial guaranty programs and the objectives and scope of coverage, as well as strategies to prevent the abuse of insurance guarantees by institutions and customers;

the issue of how regulatory strategies targeted for individual financial sectors, functions or products affect the system as a whole. Addressing this issue will require a reexamination of the allocative effects of financial guaranty programs on savings flows and other allocative strategies, including government credit programs;

problems raised by the integration of financial functions and products, including the need to introduce and enforce strategies to regulate intracompany transactions of diversified financial conglomerates, and to monitor and prevent self-dealing, tie-ins, and cross-marketing arrangements that undermine competitive equity and impair the impartiality of capital and credit decisions;

opportunities provided by innovations in information and communications technologies for more effective regulatory strategies and for closing gaps in regulation, including opportunities to monitor uncentralized markets where trading activity involves an expanding number and variety of participants, including depository institutions;

problems experienced by depository institutions in the wake of interest rate deregulation, including the need for new institutional and regulatory strategies that focus on managing liquidity and facilitate a continuation of portfolio lending;

the need for new strategies to deal with concentration, including limits on aggregate investments in individual companies in the case of institutional investors; for other intermediaries, a rising scale of capital requirements in relation to size to provide an additional cushion against loss, and;

the implications of the ballooning of debt for financial and economic stability.

As these findings suggest:

there is already abundant evidence that solutions that address only one problem or one sector of the financial services industry increase, rather than reduce, instability and risk;

changes in financial structure and regulation must be considered in the context of their impact on both the financial system and the economy as a whole, and

Congress must therefore take an active, rather than reactive, role in formulating public policy for financial restructuring, to preserve the stability and soundness of the system, promote public confidence and facilitate economic growth.

BLANK PAGE

SUMMARY

INTRODUCTION

The underlying theme of this report is that changes in financial structure—resulting from market forces, regulation, or deregulation—have important economic consequences, and that public policy decisions about the structure and regulation of financial institutions and markets must be based on an understanding of their economic impact. The current focus on "competitive equity", "convenience" and raising returns to the "consumer" of financial services understates the role that financial intermediation plays in a developed economy. Competitiveness, returns, and even strategies for protecting customers of financial institutions are irrelevant if the financial system fails to function as a dynamic catalyst in promoting economic growth. Unless the "capital users" and borrowers prosper, returns fall and intermediaries fail.

Thus this report argues that preserving the economic functions of financial intermediaries and markets to promote economic growth should be the primary objective of financial restructuring. Other objectives are important—but they are derivative.

The focus of this report is on the public policy goals that are closely linked to this central objective and that have shaped the development of the U.S. financial system since its inception:

ensuring the fairness and ease of access to capital and credit and a balanced distribution of these critical resources;

balancing competition and soundness within the financial system;

promoting diversity and impartiality in the provision of financial services by preventing conflicts of interest and concentration;

ensuring that financial institutions exercise their fiduciary responsibility in maintaining the value of financial investment by channeling funds into productive uses; and

protecting customers by ensuring the integrity of financial institutions and markets and cushioning the impact of failures.

These goals have been embedded in a structural and regulatory framework that reflected differences in financing requirements and, thus, differences in the kinds of risk faced by financial institutions and their customers. The major laws and regulations that have shaped that framework have articulated the various "missions" for the major financial sectors:

providing working capital for businesses (banks) and loans to consumers (banks and credit unions);

financing capital formation (securities firms, insurance companies and money managers) and housing (thrifts); and

assuming risk for both individuals and businesses (insurance companies).

The fact that this organizational framework is rapidly disappearing, and the effects of this change on the goals of financial regulation and national economic policy are the principal issues discussed in this report. There is now widespread recognition that enhancing competition in the financial services industry will require new strategies to maintain soundness. But those are not the only objectives affected by recent changes in financial structure and regulation. There is a need for wider recognition and discussion of the role of the financial system in distributing capital and credit, and for new strategies that will ensure a better balance in the distribution of this critical resource to meet our basic national economic goal: a balanced, stable, competitive and growing economy.

The report contains three parts. The first describes past and present developments in the financial services industry, while the second and third parts provide analyses of current trends from thematic perspectives, exploring the major objectives that have provided the rationale for the evolution of financial structure over time.

PART I: THE FRAMEWORK FOR FINANCIAL STRUCTURE AND REGULATION

Part I describes present and past debates on the appropriate role for regulation and the influence of financial structure and regulation on the economy. It discusses the evolution of the major laws governing the U.S. financial services industry, outlines recent changes in the structure of the industry, and offers, by way of comparison, a description of an alternative system—the universal banking system in the Federal Republic of Germany.

Part I also analyzes some of the factors that have contributed to changes in the structure of financial markets and their impact on the regulatory framework, including macroeconomic developments and policies, technological change, the internationalization of financial institutions and markets and changes in demand for financial services. The final chapter in this section analyzes the legislative proposals that have been considered by Congress and surveys the responses to restructuring from the points of view of various sectors of the financial services industry, the regulators and others.

Chapter 1: The current debate on regulatory policy

This chapter outlines the principal issues in the current debate on financial restructuring:

the degree to which financial institutions, services and products should be integrated;

the appropriate degree of separation between financial and nonfinancial activities such as retailing, manufacturing, etc.;

the appropriate role for regulation and/or market forces in ensuring the soundness of financial institutions;

whether or how to restructure the financial "safety net" to alleviate threats to various financial guaranty programs;

how to reorganize and rationalize the regulatory framework to reflect changes in institutional functions and products; and

the role of regulation and/or market forces in allocating capital and credit

As is discussed at greater length in Part II of this report, there is widespread recognition by most participants in the debate that finance is "special"; it is not just another service industry.

> Financial intermediaries play a unique role in facilitating the innumerable transactions that make possible our daily economic life and in transmitting the effects of monetary policy actions to the real economy.
>
> Financial institutions are private entities with public responsibilities. They must survive in a competitive marketplace while avoiding excessive risk. They only function effectively if they balance their entrepreneurial character and fiduciary responsibility in channeling other peoples' money into productive investment.
>
> The financial system's inherent fragility—the susceptibility to a mass rush to liquidate assets when confidence diminishes—justifies some form of government intervention to prevent widespread economic disruption.

In summary, the structural and regulatory framework for the financial system must ensure balance between two seemingly conflicting objectives: promoting competition and preserving soundness. This central issue in the debate—like many others reviewed in this report—has been discussed in various studies, legislative debates, regulatory decisions and judicial opinions since the 1940s. But the context for the current debate differs from that of the past in two important respects:

> the amount of restructuring that has already occurred is far greater,
>
> and the degree of restructuring advocated in recent legislative proposals is a radical departure from U.S. historical experience.

The new and critical issue in the debate involves deciding whether or not to permit all financial institutions to engage in any activity of a financial nature—in effect, ratifying the trend toward the financial supermarket by erasing all existing barriers between institutions, functions and products—and whether or not to permit commercial companies to engage in a full range of financial activities.

Chapter 2: The trend toward financial consolidation

U.S. financial history demonstrates a general adherence to a segregated model for financial structure; one characterized, as President Nixon noted, by a longstanding commitment to preserve a separation between "the suppliers of money—the banks—and the users of money—commerce and industry." [1] There have been repeated, periodic deviations from that model as well as repeated efforts to reinstate it. However, developments set in motion in the 1960s, the proliferation of ownership of insurance companies and banks by holding companies, and the growth in overseas activities of larger U.S. financial institutions, resulted in a significant erosion of the segregated structure:

---

[1] Message of the President, March 24, 1969, quoted in Conference Report 91-1747 (Bank Holding Company Act Amendments), Statement of the Managers on the Part of the House, 91st Congress, 2nd Session (1970).

many insurance companies became part of diversified financial and nonfinancial conglomerates;

bank holding companies were only restricted to activities "closely related to banking" at home--not abroad—and their domestic nonbanking affiliates were not subject to geographic restrictions; and

a relaxation of the New York Stock Exchange rule requiring that member firms be organized as partnerships permitted securities firms to expand the range of their financial activities and to form affiliations with diversified financial and nonfinancial conglomerates.

As a result of these and other developments described in this Chapter:

increasingly, financial intermediaries found themselves competing with both financial and nonfinancial entities outside their traditional lines of business;

this new competitive environment encouraged and facilitated the erosion of distinctions between financial functions and products;

adherence to a regulatory framework that continued to reflect differences in functions and products led to a proliferation of disparities in the regulation of essentially similar services;

and the proliferation of regulatory (and, thus, competitive) inequities increased pressure for a further expansion of the range of activities of individual financial institutions and sectors.

In response to this pressure, a limited amount of accommodation has been granted to depository institutions by Congress (for thrifts), more has been granted by Federal regulators, and still more by individual States. And the States, by virtue of their jurisdiction in regulating the insurance industry, have been the source of decisions permitting the integration of insurance and securities entities and products, and their integration with commercial activities.

Chapter 3: The changing financial environment

But changes in the competitive environment do not occur in a vacuum, and other, equally important forces that have shaped that environment are discussed in this chapter.

Economic developments elicit changes in the financial environment that, in turn, contribute to further economic change, perpetuating the process in a complex series of interactive responses. The amount of change in the U.S. economy over the last fifty years has necessarily forced financial institutions to make adaptive responses and resulted in a financial system that has evolved beyond the boundaries set by the legislation enacted in the 1930s in the context of very different economic conditions.

As noted, this report argues that preserving the function of the financial system as a catalyst in promoting economic growth should be the primary objective of financial regulation. Over the last two decades, both existing regulatory strategies and Congressionally mandated deregulatory efforts have failed to meet that objective. It is widely acknowledged that the inflationary experience of the 1970s had as great an impact on the financial system as on the economy itself. As nominal interest rates rose in step with the rise in prices, investment patterns shifted and savings were channeled to different financial sectors and markets. But the lag in regulatory responses to structural change reinforced imbalances in financial flows and thus aggrevated instability in the economy. For example:

> The retention of interest rate ceilings in the 1970s— a period of rising inflation—contributed to the major shifts in investment patterns that rechanneled savings to different financial sectors and markets. These changes unleashed competitive forces that have resulted in the blurring of previously segregated financial sectors, products and functions.
>
> But the removal of interest rate ceilings in the 1980s had the effect of perpetuating one of the major imbalances in credit flows that had been promoted by the inflationary experience of the previous decade: the shift from long- to short-term financial investment. Permitting the payment of market rates of interest on *insured* short-term financial assets reduced the risk-reward incentives that historically have made long-term assets attractive to investors.
>
> The result has been a decline in funds raised through new issues of stocks and long-term bonds and in the corporate sector's share of total credit—resulting, in turn, in a decline in business fixed investment and in productivity that has had important consequences for U.S. international competitiveness, trade balances and economic growth prospects.

Thus, financial structure and regulation clearly affect the allocation of credit wholly apart from the exercise of monetary policy.[2] *The fact that "financial regulation can importantly affect saving patterns in ways that have potentially large implications that extend far beyond the financial markets themselves"*[3] *must be recognized if the regulatory framework is to play a constructive role in public policy.*

Technological innovations also have had important consequences for the financial system. Some—enhanced efficiency and convenience for customers—are widely recognized. But advances in communications and information technologies are a driving force behind other changes:

> the increased volume, volatility and importance of trading activity within the financial system—even by depository institutions;
>
> increased interdependence between institutions and markets at home and abroad;
>
> and, by integrating markets previously separated by geography and differences in regulatory treatment, greater reliance on communications and information systems has made the existing regulatory framework less applicable and less effective.

Given these developments, this report suggests that improved surveillance of trading markets used by depository institutions and other financial sectors as well as by securities firms may be required

---

[2] *See also* Part II, Chapters 1 and 4.

[3] Testimony of Professor Benjamin M. Friedman, *Future of Financial Markets*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., July 14, 1983, p. 204.

to maintain systemic soundness. Technological innovations offer opportunities for more effective strategies to monitor increasingly integrated markets used by different financial sectors, but, so far, these opportunities have been underutilized.

The internationalization of financial markets, another major change in the financial environment made possible by advances in communications systems, provided a further stimulus to institutional innovation that has altered the competitive and regulatory environment. Again, regulations that were applicable to segregated or insulated financial sectors in a geographic framework that focused on the nation—or, in the case of banks and insurance companies, on the individual state—as the primary field of operations, are obviously less applicable to multinational institutions operating through integrated national and global networks.

The internationalization of financial markets also affects the ability of the monetary authority to influence financial and economic developments in the domestic market. Open markets are necessarily more vulnerable to external shocks. But the juxtaposition of a regulated and unregulated market for dollar assets—the domestic and Eurodollar markets respectively—may cause, as well as facilitate, the transmission of shocks. *The frequency of abrupt and unpredictable shifts in international capital flows exerts a potent influence on domestic financial markets—one that contributes to volatility and exacerbates the instability of the financial and economic environment.*

Consumer demand. Despite evidence of these other momentous developments, many observers nevertheless argue that changes in U.S. financial structure primarily reflect changes in consumers' demand for financial services. Like so much of the debate on financial restructuring, this assertion is too simplistic. *Changes in strategies, products and functions of financial intermediaries have tended to focus on gathering funds—an objective that primarily benefits the intermediaries themselves and the more affluent depositors and investors whose funds they seek—rather than on improving mechanisms for a more balanced distribution of credit.*

Chapter 4: Responses to financial restructuring

The widening gap between regulatory restrictions and market practices suggests to many that outmoded and inconsistent regulations, as well as market forces, bear a major responsibility for encouraging institutions to break away from traditional activities. They argue that the solution to the problem of competitive inequities that result from the increased blending of financial products and functions, is to regulate by function. This means that a given financial institution would be subject to regulation by several regulators rather than by one, with each regulator exercising those responsibilities that apply to a given activity. The debate on functional regulation reveals a wide variety of views:

> Some argue that functional regulation would permit a wider expansion of the range of activities of individual institutions because the major objection to the financial supermarket model—the problem of regulating overlapping activities in a single institution—would be resolved.

> Others argue that functional regulation may be useful in regulating some or even all of these overlaps but that it does not necessarily justify a further consolidation of activities.
>
> Still others question whether it would be possible in a consolidated institution to sort out and define the functions and products that should be assigned to particular regulators. Members of this Subcommittee have expressed doubt that such a segregated regulatory structure could be effective in monitoring intra-company transactions within a consolidated financial holding company.[4]

As these differing views suggest, there is very little consensus on how the regulatory framework should be reorganized. And there is still less agreement within the financial services industry or the Congress—or between Congress and the Administration, Federal regulators and the States—on the range of activities that should be permitted for individual institutions. Most of the debate so far has focused on the issue of expanded powers for depository institutions as the analysis in Part I, Chapter 4 of the various legislative proposals indicates.

In retrospect, the only real area of consensus that developed out of that debate was that Congress should decide the issue. And now—in the aftermath of court decisions on regional interstate banking compacts and nonbank banks [5]—the cohesion around even the preference for that procedural strategy has fragmented.

Nevertheless, it is widely acknowledged that "the *status quo* makes absolutely no sense whatsoever"—that:

> The resulting pattern of regulation really gives us the best of neither world, neither the efficiency advantages of free markets nor the kind of protection accorded by a fully regulated market . . . In some areas there is much too much regulation, and in other areas too little.[6]

Moreover, it is evident that the financial system is less sound than in the past and many believe that the absence of a coherent regulatory framework may have eroded the effectiveness of soundness regulation and customer protections. A witness before this Subcommittee stated: "It is not that we feel deregulation is needed; it is more rational regulation." [7]

As these remarks suggest, "deregulation" is the wrong word. The use of the term "deregulation" does not have the same meaning for financial institutions as for the airline, telecommunications, or trucking industries. Nevertheless, the justifications for relaxing regulatory restrictions—to increase competition and lower price, to improve entry and exit, and provide more information for competitors and customers—are the same. If these were the only concerns applicable to financial services, then deregulatory efforts comparable to those for other industries would be appropriate. They are not. As outlined above, financial services differ from services provided by nonfinancial companies, and the institutions involved are uniquely vulnerable. This has very important implications for defining the goals of financial regulation.

---

[4] These and other views on functional regulation are discussed in Part I, Chapters 1 and 4, Part II, Chapters 2 and 3, and Part III, Chapters 1 and 2.

[5] *Northeast Bancorp Inc.* v. *Board of Governors of the Federal Reserve System*, 472 U.S.—105 S.Ct. 2545, 86 L.Ed. 2d 112 (June 10, 1985) and *Board of Governors of the Federal Reserve System* v. *Dimension Financial Corporation*, No. 84-1274 (Jan. 22, 1986).

[6] Testimony of Stephen J. Friedman, Partner, Debevoise and Plimpton, *Expanding Securities Markets: Regulatory and Economic Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, May 2, 1985, Serial No. 99-21, p. 316.

[7] Testimony of Roberto Mendoza, Vice President, Morgan Guaranty Trust Co., *Ibid.*, p. 333.

PART II: THE GOALS OF REGULATION

Introduction

Part II of the report deals with the goals or objectives that have provided the rationale for laws governing financial regulation in the past: enhancing the fairness and ease of access to capital and credit and ensuring a balanced distribution of these critical resources; balancing competition and soundness; assuring diversity and impartiality in the provision of financial services by preventing conflicts of interest and concentration; ensuring that financial institutions meet their fiduciary responsibility in maintaining the value of financial investment by channeling funds into productive uses, and protecting customers by ensuring the integrity of financial institutions and markets and cushioning the impact of failures. This section discusses perceptions of threats to these goals that may result from changes in financial structure, and suggests some of the policy concerns that may be posed by these threats, involving either impediments to economic performance or other significant social costs.

There is a unifying theme in the extensive body of law and regulation governing U.S. financial institutions: *recognition of the financial system's economic role.* Unless the system as a whole facilitates the transformation of financial capital into economic activity and growth, other objectives and strategies—including those that protect customers—will be ineffective. Lack of growth weakens both the economy and the value of the financial investment behind it. Thus:

> Laws and regulations that require disclosure, portfolio diversification and margin requirements on credit-financed purchases of stock, or that prevent conflicts of interest, fraud, financial manipulation and excessive speculation, guard against diversions of financial resources into nonproductive uses.
>
> They also serve as a reminder to financial institutions that the fiduciary responsibility to make credit decisions that maintain the value of investment is so critical to the well-being of the economy that it is a quasi-public responsibility.

Reflecting the primacy of the fiduciary nature of the services offered by these institutions, another central objective of regulation and supervision is to protect their customers. Whether that customer is an individual, a company, a government agency or another financial institution; a depositor, investor, policy holder, borrower, or securities issuer—each receives a substantial degree of protection.

The kinds of protection offered to customers of financial institutions vary greatly and involve many different strategies. There are, however, significant relationships among objectives and strategies. For example:

soundness regulation, intended primarily to protect the institution itself, is also a primary tool for protecting individual customers, communities and the nation as a whole from the disruptions and loss of income associated with financial failures;

preventing conflicts of interest and the concentration of financial resources promotes both soundness and competition; but

regulatory strategies that prevent conflicts of interest and concentration—together with those that require portfolio diversification by institutions to promote soundness and competition—also ensure a greater degree of fairness in the allocation of capital and credit, the key objective of laws and regulations that protect customers who raise funds in financial markets.

The structure of the financial system also plays a role in influencing the performance of its economic function. The segregated structure that has characterized the American financial system has been associated with specific "missions" for the various financial sectors. For example:

securities firms and markets perform the function of channeling long-term financial investment into capital formation;

the "mission" of the insurance industry is the assumption of risk for both individuals and companies—a role that is vital to the operation of U.S. businesses. But its financial function—like that of other institutional investors that manage pension funds, trust accounts and other pools of savings for beneficiaries—involves the investment of huge financial resources and thus entails a major role in capital formation;

the traditional role of commercial banks has been to use short-term deposits to provide working capital for businesses and loans to consumers;

thrifts are repositories for household savings used to finance long-term, fixed-rate mortgages for housing;

and credit unions use household savings for consumer lending.

These "missions" have tended to be defined and encouraged by limitations on the functions and/or portfolio strategies of the various types of institutions which serve to channel savings and credit to a given economic sector. It is argued that this structural strategy—

helps to ensure adequate financing for all economic sectors and thus to promote balanced growth and economic stability—that, at a minimum, it has a clear impact on the allocation of capital;

fosters a broader spectrum of opinion in the financial decision-making process by promoting the diversity and multiplicity of sources of finance;

prevents conflicts of interest and concentration (which are also viewed as impediments to impartiality in credit decisions made by individual institutions);

requires less regulation than would an integrated structure because there are fewer opportunities for integrated transactions—i.e., the sale of a house, the provision of mortgage credit and of insurance, and the issuance and underwriting of mortgage-backed securities—and thus less need to police transactions to ensure that they are conducted at arms-length and do not involve coercive tie-ins; and

promotes a higher level of managerial competence in providing financial services.

The breakdown of the segregated financial structure has undermined effective implementation of traditional regulatory objectives and has altered their impact on the economy. Some of these consequences are discussed in the following summaries of the four chapters in Part II of this report.

Chapter 1: Access to capital and credit

The fairness and ease of access to capital and credit has been a recurrent theme in U.S. public policy debates for more than a century. The consensus view that fairness is crucial in preserving the confidence necessary to promote economic growth has resulted in a substantial role for government in financial markets. But U.S. financial structure and regulation embody two seemingly conflicting views on intervention strategies:

on the one hand, they reflect the belief that financial structure and regulation should ensure neutrality in credit flows;

on the other, that government should intervene directly to allocate credit to specific sectors.

Both views have resulted in efforts to alter the effects of what were viewed as imperfect markets for credit allocation. Moreover, a degree of compatibility between these views has been achieved by a basic framework for financial structure and regulation that emphasizes impartiality in credit decisions made by individual institutions, with an overlay of allocative mechanisms that make use of additional structural and regulatory strategies, tax policies and government credit programs. Many believe that the U.S. Government's extensive influence on financial markets through monetary, regulatory and tax policies, and the role it plays in financial intermediation through more than 350 credit programs constitutes a substantial restraint on the potential for market forces to play a dominant role in allocating credit.

The segregation of financial functions and other structural and regulatory strategies used to ensure a "mission" for specific financial sectors also developed as a result of concerns about access to capital and credit. Different sectors traditionally have managed investment strategies involving different risks and maturities. For example:

Securities markets and institutional investors that use those markets dealt primarily with long-term investment and borrowing strategies.[8] Because of the inherent risk that financial and economic conditions will change over time, the efficiency of long-term financial markets depends upon their liquidity. The breadth and depth of secondary markets for securities provide flexibility for investors in long-term financial assets and help minimize the risk of changes in financial and economic conditions. But well-developed secondary markets also benefit the issuer of long-term debt and equity securities by reducing the cost of floating new issues.

---

[8] The recent shift to shorter-term strategies is discussed below and in Part II, Chapter 4.

Institutions such as banks that fund short- and medium-term loans with short-term liabilities face different risks. Their primary concern—and that of their depositors—is immediate liquidity. Because they must be able to pay out depositors' funds within a short time frame or on demand, the efficiency of their managerial strategy depends upon their ability to match the maturity and interest rate spread between sources and uses of funds. The degree of risk involved in matching the maturity and return on loans relative to deposits led, by way of panic and bank closures, to provisions in the 1933 Act that created the Federal Deposit Insurance Corporation (FDIC), prohibited interest payments on demand deposits and imposed interest ceilings on savings deposits. Deposit insurance reduces the risk to depositors while interest rate ceilings reduced the risk to banks. This stabilized both the availability and cost of deposits and lowered the cost of loans—a gain in efficiency from the perspective of borrowers.

The specific strategies developed by financial institutions to cope with rising interest rates in the 1970s, and the subsequent responses of Congress and the regulators, have resulted in a consistently interactive pattern of behavior that has altered the differences in the missions of the various financial sectors and perpetuated, rather than reduced, competitive inequities. For example:

The deregulation of interest rate ceilings on large negotiable certificates of deposit (CDs) in 1970, in combination with a rising rate of inflation, was an important factor in eroding inducements for investors to buy corporate stocks and bonds. Securities firms and mutual funds responded to the loss of business by developing a competitive product—money market mutual funds (MMMFs).

Because MMMFs invested heavily in large negotiable CDs issued by large banks, smaller banks and thrifts experienced the brunt of the competitive advantage that MMMFs enjoyed—i.e., their exemption from interest rate ceilings, reserve requirements and deposit insurance premiums. But these regulatory advantages allowed securities firms to pay a higher rate than even large banks on what were essentially short-term, uninsured deposits with transactions features. In response, large banks increased their reliance on nonregulated sources of funds such as repurchase agreements, Eurodollar borrowings and the interbank market, to improve their ability to compete with MMMFs throughout the 1970s.

But as investments in MMMFs grew, interest rate ceilings were relaxed and—after an increase of over $100 billion in MMMF assets in 1981—the Garn-St Germain Act of 1982 authorized the creation of money market deposit accounts (MMDAs) to establish competitive equity between depository institutions and MMMFs.

The introduction of MMDAs and the reflow of funds back to depository institutions, however, helped spawn yet another hybrid, the nonbank bank, which became particularly attractive to securities firms (as a way to perpetuate their money market mutual fund business by gaining access to Federal deposit insurance), to commercial firms that offer consumer credit (to gain access to the payments system), and to bank holding companies (to evade restrictions on interstate banking).

None of these institutional and regulatory responses has succeeded in restoring a more balanced sectoral or maturity distribution of credit flows, or in reinstating or redefining the "missions" of financial sectors and institutions. The report's findings suggest that—

interest rate deregulation has made it more difficult for banks to perform their traditional role in intermediating between the short-term preferences of depositors and the longer term preferences of borrowers. Thus, a growing portion of the assets of depository institutions are invested in the same kinds of money market instruments in which MMMFs invest and for the same reason—the need to match interest-sensitive, short-term assets and liabilities in the same maturity range—with the result that *almost half of all commercial banks now invest less than 10 percent of their funds in commercial loans;*

the impact of interest rate deregulation on consumers has not been a rising tide that has raised all boats. Not only do consumers continue to pay exorbitant real rates of interest on credit cards issued by banks and retailers and on other borrowings, they also pay higher fees for traditional banking services. Moreover, the quantity and location of branch closings has followed a distinct pattern: small, poorer communities lose access to banking services. Meanwhile, there has been a dramatic expansion of banking and other financial services targeted at upper-income consumers; and

many of the institutional and regulatory responses have reinforced developments that have tended to reduce capital and credit flows to businesses—large and small—and thus to impede capital formation, job creation and future economic growth.

Because many of the market imperfections and distortions in credit flows that developed in the 1970s appear to have been associated with allocative mechanisms, support has grown for increased reliance on market forces in distributing capital and credit. Those who favor "deregulation" as a means to obtain this objective advocate removing most of the structural and regulatory strategies that have been used to define the missions of various financial sectors.

Pointing to the Euromarkets as an example of a deregulated environment, this report argues that greater reliance on market forces may not result in more balanced credit flows. The absence of regulatory costs in the Euromarkets lowers the cost of funds to borrowers and raises returns to investors. But these gains in efficiency are also associated with:

more rapid movements of essentially short-term funds;

the large scale of transactions; and, therefore,

limitations on access to Euromarkets that preclude direct participation by *small* borrowers and investors.

Moreover, the unleashing of market forces in the Euromarkets failed to prevent concentration in lending or to prevent overlending that has threatened economic and political stability in a number of countries, and the soundness of the financial system as well.

In short, while a further erosion of the historic "missions" of financial institutions may be inevitable, the report notes that:

> continued unwinding of the structural and regulatory framework may result in a system for distributing capital and credit that is less fair *and* less efficient in promoting economic growth than in the past;
>
> to retain the desirable degree of neutrality and balance in financial flows that is a goal of any market system will require an analysis of individual structural and regulatory strategies to ensure impartial credit decisions by individual institutions;
>
> an evaluation of existing allocative programs and strategies is needed as well, and
>
> *failure to examine these issues, or to focus on other key regulatory goals that have shaped the framework for financial regulation in the past, could create new, unintended distortions in capital and credit flows that may undermine valid economic objectives for assuring wider and more equitable access to financial services.*

Chapter 2: Balancing competition and soundness

The current emphasis on increasing competition in the financial services industry is relatively new. The framework for financial structure and regulation has previously evolved in the aftermath of crises, when "soundness" regulation has received priority attention in order to maintain public confidence in the financial system. Now, many of the basic elements of soundness regulation are under attack, including:

> prohibitions on self-dealing;
>
> restrictions on requirements relating to the nature and quality of assets;
>
> regulation of the liability structure of intermediaries including capital, reserves and liquidity requirements, and
>
> controls on engaging in other kinds of businesses.

These safeguards necessarily act as a constraint on competition. They limit:

> the investment opportunities of intermediaries;
>
> the asset and liability products they can offer and,
>
> the profitability of financial firms, by restricting their ability to leverage operations and expand into new areas.

The removal of these safeguards is, therefore, a primary objective of advocates of a more competitive financial services industry.

But the historical experience of crises is evidence that the "susceptibility of the financial sector to such upheavals, its fragility, is one of the externalities that justifies some form of government intervention."[9] *And because "deregulation often involves abandoning pre-*

---

[9] William L. Silber and Kenneth D. Garbade, "Financial Innovation and EFTS: Implications for Regulation," *Compendium of Papers Prepared for the FINE Study*, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Cong., 2nd Sess., June 1976, Book I, p. 197.

cisely those regulatory devices designed to promote soundness",[10] *the issue of balancing competition and soundness has moved to the forefront of the debate on financial restructuring.* Thus:

> those who advocate removing constraints on the ability of financial institutions to engage in other kinds of business propose that different nonbanking activities be conducted in separate subsidiaries, and argue that the separate subsidiary structure will permit the appropriate regulator to oversee the activities of a consolidated financial enterprise as effectively as would be the case, now, with independent firms.
>
> others are skeptical that the separate subsidiary structure will effectively insulate a bank or any other subsidiary engaged in financial activities from the problems or failures of affiliates.

Underlying this debate on strategies is the issue of what role market forces should play in ensuring soundness. At the extreme are those who imply that increasing competition will displace the need for soundness regulation—or argue, at least, that in a truly competitive environment, market forces, rather than direct regulation, are the appropriate instruments for ensuring soundness as well as promoting competition. And they believe that releasing competition and market forces will require that market participants have all necessary information to conduct meaningful risk analysis; that disclosure will be "an integral part of the free market model." [11]

The appropriate role for disclosure with respect to depository institutions is an increasingly controversial issue in the debate on financial restructuring: [12]

> Many argue that disclosure can undermine the confidence that soundness regulation is intended to promote; that, because it can precipitate a "run on the bank" that may affect other institutions that are otherwise sound, the "discipline" it engenders may be counterproductive, to say the least.
>
> Others note that, given the rising level of instability and risk in the financial system, it is difficult to justify denying investors and customers the benefits of full disclosure.
>
> This report argues that reliance on disclosure as the *primary* tool of soundness regulation will tend to increase, rather than reduce, the regulatory burden because of the kinds and amount of information that financial institutions will be required to disclose for meaningful risk analysis. It will also place often unmanageable burdens on the growing number of analysts—individuals, small businesses and local school districts, for example—who will have to digest it.

Moreover, there is reason to doubt that market discipline will increase efficiency. As one analyst of the issue argues:

---

[10] Bevis Longstreth, "In Search of a New Safety Net for the Financial Services Industry", Article included in *FDIC Securities Proposal and Related Issues*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., Serial No. 98-46, June 16, 1983, p. 100.

[11] Longstreth, *op. cit.*, p. 100.

[12] See this chapter of the report (Part II, Chapter 2) and Part III, Chapter 2.

> Indeed, a major efficiency of financial intermediaries is *precisely* that it frees capital suppliers from having to know about portfolio management . . . It would make little sense, obviously, to hold capital suppliers at their own peril to assess and assume whatever risks were presented by the intermediaries, since that would force them to duplicate the portfolio managers' efforts and thus defeat the scheme.[13]

A greater role for market forces in promoting soundness may also result in a greater number of failures. The market can only exert discipline if it can cause failures. And it is this aspect of market discipline that has led many—including those who favor an expansion of the powers of banks and other intermediaries—to question the scope and pace of financial restructuring and to resist efforts to jettison direct regulation altogether.

No one denies that market discipline will increase the rate of failures. But can we afford those failures?

> The fact that increased interdependence between financial institutions and markets enhances the risk of systemic crises in the event of individual failures suggests we cannot.
>
> Because some intermediaries have grown so large relative to the size of the industry as a whole,[14] many (including, apparently, the U.S. government in the case of Continental Illinois) believe that the failure of a large institution could create unacceptable costs in terms of the stability and prosperity of the U.S. and world economies.
>
> Consolidating financial functions is likely to increase interdependence and may result in even larger institutional structures.

Thus, this report argues that the need to devise new ways of minimizing or managing risk should be a paramount concern in the discussion of financial restructuring:

> that the competitive forces unleashed by interest rate deregulation must be balanced by "soundness" regulation that focuses more on depository institutions' new problems in managing liquidity;
>
> that the expansion of securities markets and more dominant role for trading activity, resulting in a financial system in which distinctions between lending and investing are becoming more blurred, underscores the need to focus on the *kind* of regulation that is appropriate, rather than the way regulation is packaged;
>
> and that a more useful first step in financial restructuring would be to focus on the structure of uncentralized markets (e.g., for government securities, commercial paper, certificates of deposit, mortgage-backed securities and foreign exchange) and on introducing opportunities for surveillance and monitoring trading by all participants in these markets.

In short, critics of current proposals for financial restructuring (and Members of this Subcommittee) are in search of some means of

---

[13] Robert Charles Clark, "The Four Stages of Capitalism: Reflections on Investment Management Treatises", *Harvard Law Review*, Vol. 94, No. 3, January 1981, p. 571.

[14] The issue of institutional concentration is discussed in Part II, Chapter 3.

retaining "essential safeguards", for the financial system, "including an adequate supervisory framework".[15] Most *agree that a new system is needed and that it should incorporate provisions for direct regulation as well as an enlarged role for market forces in disciplining excessive risk-taking. Above all, it must meet the ultimate test of the government's responsibility for soundness: the provision of a rational safety net "that can avert or arrest a pending financial crisis."*[16]

As of this date, the major spokesmen for this view have offered only a "sketch of the desired structure".[17] For the most part, the details are missing. But they have raised important questions about the potential effectiveness of deregulatory initiatives in promoting soundness. Their contribution has been to provide a counterweight for a debate that has focused primarily on the benefits of releasing competitive forces.

Chapter 3: Promoting competition and the impartiality of credit decisions

This chapter discusses the inherent conflicts between traditional structural and regulatory strategies used to promote competition and the trend toward integrating financial functions and products. It begins by noting the objectives of a segregated system: to ensure diversity, increase the number of market participants, and promote impartiality in credit and capital decisions. These objectives contribute to the efficiency of the market system. For example:

> A structural framework that promotes independence and specialization helps ensure that transactions are conducted at arms-length and decisions made on the merits of the investment rather than in the interest of intermediaries and their affiliates.
>
> A greater number of decision-makers ensures that those speculative activities that are necessary for markets will have an equilibrating function rather than develop into "bandwagon effects" that produce panics.
>
> The segregation of financial institutions and functions serves to stabilize the financial system itself because it tends to insulate the system as a whole from the problems of individual institutions and sectors.
>
> And, by offering alternative sources of capital and credit to borrowers, a diversified system also helps stabilize the economy and promote economic activity.

The trend toward consolidation will require the development of new regulatory strategies if these goals are to survive. And the need is immediate, not prospective. While the major sectors of the financial services industry are still dominated by specialized, independent institutions (property-casualty insurers are the exception), with national markets served by large institutions and a competitive fringe of smaller, regional and local firms, evidence presented in this study shows that the movement toward financial conglomerates is well underway: [18]

---

[15] Statement of Paul A. Volcker, Chairman, Federal Reserve Board of Governors, *Moratorium Legislation and Financial Institution Deregulation: Hearings on S. 1532, S. 1609, and S. 1682* before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 98th Cong., 1st Sess., September 13, 1983, p. 12.

[16] Longstreth, *FDIC Securities Proposal and Related Issues, op. cit.*, p. 130.

[17] *Ibid.*, p. 105.

at least five large financial conglomerates are engaged in all three major financial functions (insurance, securities and depository activities) plus real estate and other financial activities;

21 other financial conglomerates are engaged in one or more of the major financial functions, as well as a number of other less important financial activities;

15 of these 26 diversified financial conglomerates are owned by commercial companies; and

any number of other, smaller financial institutions and nonfinancial companies are also offering financial services outside their traditional lines of business.

In view of the degree of consolidation that has already occurred, this report illustrates how transactions may be integrated in a financial services conglomerate. It suggests that:

credit standards may be relaxed because the various affiliates involved in different stages of an integrated transaction—such as, again, the sale of a house, the provision of mortgage credit and of mortgage insurance, and the issuance and underwriting of mortgage-backed securities—may not question the evaluations and decisions made by others. Each may assume that its relationship to the others and to the parent company reduces the risk it otherwise might face as an independent company. The goal may be to maximize the profits of the company as a whole rather than preserve the viability of individual units.

The financial conglomerate itself is not free from risk in such a scenario. Losses sustained by any affiliate will inevitably weaken the whole company. Thus, consolidating financial services and creating the synergisms that result in a higher level of profit than can be earned through specialization may require a different (and perhaps higher) level of managerial skills to assess the appropriate mix of intra-company risks and rewards.

Those skills may subordinate fiduciary responsibility to the imperatives of efficiency and market survival. More of the risk may be shifted to customers, and may result in a deterioration of credit quality, more defaults and greater losses to investors.

The risks of a loss of impartiality. The above outcome would be particularly troubling if it involved depository institutions:

banks can tie sources and uses of funds—i.e., they are largely funded by their borrowers—and create deposits by lending;

they are the only institutions that issue liabilities to all sectors of the economy and extend credit to all private and public borrowers;

these powers give banks a unique role in the financial system as "the primary source of liquidity for all other classes

---

[18] See Part II, Chapter 3, Chart B

> and sizes of institutions, both financial and nonfinancial . . ."[19]

Because other financial sectors depend on banks for liquidity under normal circumstances, they worry whether banks, if they become competitors, "will still be enthusiastic, reliable lenders to us."[20] That concern would increase in periods of stress, and "underscores the importance of rigorous and impartial credit judgments by banks . . . (which) in turn, provides a particularly relevant context in which concerns about the commingling of banking and other interests should be evaluated."[21]

Securities firms and insurance companies also have unique economic functions that require impartiality in the decision-making process:

> Securities firms act as impartial middlemen between issuers and investors. Their impartiality is critical in promoting market integrity and investor confidence and may be compromised if—as a result of involvement in activities other than traditional broker-dealer and underwriting functions—they, themselves, become issuers or investors, or affiliates of issuers or investors.
>
> Impartiality is no less a critical factor in assuring that insurance companies perform their economic function in assuming risk for all sectors and that their investment decisions are made at arm's length and in the interest of their fiduciary responsibility, rather than the interest of affiliates. Involvement in commercial or financial activities other than insurance may distort their impartiality both as insurers and investors.

To illustrate these concerns, the report provides a number of examples of actual and potential problems that may arise as the trend toward financial consolidation continues, focusing on those problems that traditionally have been viewed as impediments to competition and the impartiality of credit decisions: conflicts of interest, cross-selling and tying financial services, and the concentration of financial resources. *The discussion does not focus solely on banking. It suggests, rather, that the current focus on depository institutions has tended to obscure the trend toward a rising level of conflicts of interest outside the banking system that, left unchecked, could lead to a higher level of risk, increase fragility and undermine confidence in the financial system as a whole.*

Overall, this chapter concludes that:

> opportunities for self-dealing and cross-selling may be inherent in the financial institutions holding company structure, and may tend to distort credit and investment decisions even when, as now, there are many competing sources of services;
>
> the loss of impartiality—e.g., when transactions are not conducted at arm's-length or when investments are made in the

---

[19] E. Gerald Corrigan, "Are Banks Special?", *Annual Report/1982*, Federal Reserve Bank of Minneapolis, p. 10.

[20] Statement of John C. Whitehead, Senior Partner, Goldman Sachs & Co., *The Future of Financial Markets*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., Serial No. 98-42, July 14, 1983, p. 192.

[21] Corrigan, *op. cit.*, p. 11.

interest of affiliates rather than on their own merits—will detract from fairness and restrict access to capital and credit;

regulatory strategies to prevent conflicts of interest and tie-ins, or to monitor intra-company transactions, either do not exist or—if, as in the case of banks, they do exist—as a practical matter, can't be policed;

the complexity of a regulatory framework that divides responsibility among Federal regulators and between those at the Federal and State levels, could make it virtually impossible to seriously police anticompetitive transactions within a financial conglomerate, and

the absence of effective restraints on such practices is an issue important enough to be addressed in proposals for regulatory restructuring, with or without further changes in the powers of financial intermediaries.

The risk of excessive concentration. Because much of the consolidation of financial functions that has occurred so far has been accomplished by way of mergers and acquisitions, a continuation of the trend could reduce the number of independent decision-makers in the financial system and increase the concentration of financial resources. Concerns about excessive concentration have begun to surface with increasing frequency:

banks point to the high level of concentration in the securities industry and propose that banks be allowed to underwrite corporate securities to increase competition;

the relaxation of restrictions on interstate banking has been structured by the individual states to prohibit or slow the expansion of money center banks to prevent their dominating the industry, while the eased restrictions advance the interests of large state or regional banks.

The evidence presented in this report validates these concerns.[22] The U.S. financial services industry is already highly concentrated at the top even if remarkably diversified at the bottom.

In each sector, a very small number of institutions account for half of that sector's activity and resources—less than one percent of the total number of firms in the securities, banking and life insurance industries; about two percent of the total number of property-casualty insurers and a little more than four percent of all thrifts. In short, the major financial sectors are dominated by a handful of very large institutions with numerous small institutions competing at the fringes.

A comparison of the data for individual industries supports the conventional view that the securities industry is the most highly concentrated of the major financial sectors in terms of *function.*[23]

---

[22] See Part II, Chapter 3, Tables 11-16.

[23] It should be noted, however, that the data on securities activities excludes the currently extensive role of banks. As shown in Table 2, Part I, Chapter 4, banks are currently eligible to underwrite about 50 percent of all securities (including U.S. government securities) issued in U.S. financial markets and their share would have risen to 75 percent under the new powers authorized in the bill passed by the Senate in September 1984. Moreover, they are now allowed to underwrite an even wider range of securities abroad. Other data presented in Part II, Chapter 3 (footnote 67) show that banks' current share of domestic markets for bank-eligible securities is sizable even though the data only reflect participation by the largest banks.

But in terms of the *control of financial resources*, ten bank holding companies dominate the financial services industry as a whole with aggregate capital equal to more than twice the total capital of the entire securities industry, and aggregate assets ($724 billion or 25 percent of total banking assets) equal to the total assets of all life insurers, almost three times the assets of all property-casualty insurers and only about $250 billion less than the total assets of the thrift industry.

Large bank holding companies already play a major role in more than one market. The largest companies' share of the market for securities that can be underwritten by both banks and securities firms is estimated to be over 25 percent and the top ten companies manage $247 billion of assets for beneficiaries in addition to their banking assets.

Thus, as the data on banking and other financial sectors suggest, current levels of concentration may have important implications—

for the soundness and stability of the financial system as market forces assume a larger role in disciplining institutions that may result in a higher rate of failures of large institutions;

for the stability of the economy in terms of the need for a balanced distribution of capital and credit, and

for the market system itself as investment and credit decisions increasingly rest in the hands of fewer decision-makers.

Chapter 4: Preserving the economic functions of financial markets

As stated in the introduction, the report's underlying thesis is that the ultimate purpose of the framework for financial structure and regulation is to assist financial institutions and markets in performing their economic functions.[24] Throughout history, the failure of financial markets to assure that funds are productively employed has played a significant part in precipitating major economic dislocations. While financial regulation cannot guarantee that mistakes will not be made or excessive speculation prevented, public policy can play a decisive role in moderating these tendencies by requiring:

that financial intermediaries meet their fiduciary responsibilities, and

that the financial system is structured to meet the needs of the economy.

Thus the 1930s legislation—recognizing that different financing needs required different financial instruments and strategies—clarified the structure and "missions" of the various financial sectors, and introduced new restrictions to assure that intermediaries would perform their economic functions in allocating savings to productive uses.

---

[24] Professor James Tobin has described the economic functions of financial industries as including "the pooling of risks and their allocation to those most able and willing to bear them, a generalized insurance function . . . [that] enables economic agencies to insure for themselves deliveries of goods and services in all future contingencies . . ."; "the facilitation of transactions by providing mechanisms and networks of payments; the mobilization of saving for investments in physical and human capital, domestic and foreign, private and public, and the allocation of saving to their more socially productive uses" ("On the Efficiency of the Financial System", Hirsch Memorial Lecture, New York, NY, May 15, 1984, p. 4).

The impact of recent changes in the financial environment on the structure and missions of intermediaries and on the flow of savings, capital and credit has been discussed elsewhere in this summary. This final chapter of Part II focuses on the impact of these shifts on capital markets and on capital formation. It begins with an examination of capital investment trends—which ultimately affect productivity, international competitiveness, changes in GNP, job creation and standards of living—and finds that:

> the share of national income devoted to net nonresidential fixed investment—that is, to capital formation exclusive of housing—fell in the 1970s below the levels of the previous two decades and declined further in the 1980s; and
>
> while the macroeconomic environment and other factors obviously exerted a powerful influence on investment decisions, these trends also are closely associated with developments in U.S. capital markets—in particular, their failure "to provide, on a continuing basis, a significant net new source of capital for business . . ." [25]

Developments in U.S. capital markets over the last decade are clearly reflected in the aggregate balance sheet of the business sector:

> the ballooning of debt that has pushed the ratio of debt to equity to an historically high level;
>
> a decline in the maturity of corporate debt and in liquidity, and
>
> an increase in risk.

And the position of financial intermediaries mirrors these results. They, too, are highly leveraged by historical standards and are faced with the risks posed by a deterioration in credit quality that has been the consequence of both the upward surge in debt and the downward pressure on its maturity.

The ways in which the business and financial sectors have adapted to these developments have resulted in important structural changes, some of which are discussed below. In examining specific changes in the institutional structure and functions of securities markets, this report finds that:

> on balance, there is little evidence that these changes have helped promote capital formation, and
>
> some of these changes may, themselves, now contribute to perpetuating the uncertainty, instability or volatility they were devised to offset.

Institutional investors. The emergence of institutions as the dominant group of investors has important consequences in terms of the economic functions of capital markets. Their dominance is reflected in the fact that:

> At year-end 1985, institutional investors as a group owned 35 percent of outstanding U.S. corporate stocks, 78 percent of outstanding U.S. corporate and U.S.-issued foreign bonds, 44 percent of outstanding Treasury debt, and accounted for 70 per-

---

[25] Henry Kaufman, Executive Director, Salomon Brothers, Inc. "Dangers in the Rapid Growth of Debt: The Need for a National Policy Response", a talk delivered before the National Press Club, Washington, D.C., January 16, 1985, p. 5.

> cent of trading on the New York Stock Exchange, up from 20 percent in 1960.
>
> Pension funds became the largest and fastest-growing segment of this group of investors as an ever-increasing share of U.S. saving was channeled into private retirement plans and they stepped up their purchases of financial assets to meet ERISA's 1974 funding requirements. They now own 21 percent of outstanding U.S. equities.

As the share of corporate equity held in pension funds has grown larger, tensions between the historic objectives of securities law and regulation and the objectives of pension fund managers have sharpened. The emphasis under ERISA on the fiduciary responsibility of pension funds contrasts markedly with the profile of the typical investor of the past. For example:

> Investment in securities issues of new companies involves an element of risk that, historically, has been rewarded by a higher rate of return. The commercialization of new technologies is made possible by securities investors who are willing to accept significant financial risk—speculating, in an economic sense, on the future prospects of new products and industries.
>
> But the fiduciary responsibility of pension fund managers implies a different investment strategy: achieving the maximum return for beneficiaries with minimal risk. Thus, these investors are less likely to invest in new companies or support established companies' investments in research and in new products and technologies.[26]
>
> And because gains in the value of holdings allow employer-sponsors of defined benefit plans to reduce contributions in the following quarter or year, a manager's performance is often evaluated on the basis of short-term gains (or losses), using overall market performance as the standard. This may tend to discourage investment strategies that focus on the long-term growth-potential of companies whose shares a fund holds.

Pension fund managers' apparent disinterest in long-term gains is reflected in—

> the rapid turnover of pension fund portfolio holdings; [27]
>
> their preference for seasoned issues of large, established companies that can be bought or sold easily in large amounts; and
>
> their more recent preference for index funds.

Again, these are strategies that do not directly benefit new issues markets—particularly for smaller or emerging companies—and may not add to the liquidity of the secondary market and thus indirectly benefit the new issues market.

The higher turnover rate of pension fund portfolios and block trading tends to increase the volatility of securities prices and, as many believe, may have discouraged individual participation in the market. The value of individual holdings of stocks fell by $398.9 billion in the period 1978 through 1985, while the value of holdings of institutional investors rose by $221.1 billion.[28] This represents a significant reduction in the number of trading partners and decision makers in the market, a development that could disadvantage small or new companies and emerging industries as a more concentrated group of risk-averse investors increasingly dominates the process of choosing winners and losers.[29]

---

[26] Although pension funds provide the largest share of capital to private venture firms (33 percent in 1985), the amount ($767 million) is relatively small. Moreover, venture capital is a special case and venture firms a small segment of the business community compared with the number of small business firms and companies that raise funds through securities issues.

[27] Their exemption from the tax consequences of the rapid turnover of holdings also is a contributing factor.

Pension fund structure and investment strategies also may undermine traditional notions of corporate democracy. For example:

> while managers control shares held in pension fund accounts, it is unclear who owns the companies whose shares are held—the beneficiaries (employees) or the sponsor (employer);
>
> thus the applicability of shareholder rights is equally unclear. Voting rights in all companies whose stocks are held in a given fund are exercised by the fund manager as a function of "fiduciary responsibility". But "fiduciary responsibility" in this context is no more clearly defined than is ownership.

In summary, the growth in pension funds has concentrated corporate governance in far fewer hands. And with institutional ownership of the outstanding shares of some large companies as high as 60 to 80 percent, money managers now have a decisive role in corporate governance and in deciding the outcome of takeover battles.

Mergers, takeovers and other stock retirement strategies now exert a dominant influence on securities markets, prompting widely divergent views as to their causes and benefits. For example:

> Many corporate managers believe that institutional investors exert considerable pressure on companies to adopt short-term performance objectives and that their investment objectives have contributed to a climate that has encouraged a proliferation of mergers, hostile takeovers, leveraged buy-outs and stock retirements.
>
> Others believe the recent rash of takeovers, leveraged buy-outs and stock retirements is the result of other market imperfections—that "capital costs are too high, stock prices too low." [30]
>
> Raiders argue that they are prompted by—and are the appropriate means to correct—poor management strategies that have undervalued assets and, thus, returns to shareholders.
>
> Still others focus on the prevalence of asset sales in the aftermath of takeovers and leveraged buy-outs as an indication

---

[28] See Part II, Chapter 4, Table 13.

As discussed below, stock retirements have significantly reduced the aggregate value of outstanding equities. Thus the growth in individuals' *indirect* holdings (through pension funds and stock mutual funds) has not kept pace with the decline in direct holdings. The dramatic growth in mutual funds in 1985, for example, primarily involved increases in funds that invest in money market instruments, Ginnie Maes, Treasuries and tax-exempt securities—not corporate stocks and bonds. These data suggest that discount brokerage, another important institutional innovation, has made little direct or indirect contribution to the market for new equity issues. While it has benefitted both individual and institutional investors by increasing competition, reducing transactions costs, and increasing convenience (by facilitating the entry of depository institutions into securities brokerage), the advent and growth of discount brokerage has resulted in a redistribution of market shares rather than an expansion of the retail market for stocks and bonds, and thus adds little to market liquidity.

[29] See Part II, Chapter 3, Table 9 for evidence of concentration among money managers.

[30] Alan Greenspan, "Takeovers Rooted in Fear", *The Wall Street Journal*, September 27, 1985, p. 28.

> that the current trend is a mirror image of diversification strategies undertaken in the 1960s and 1970s that are ill-suited to the 1980s.

Despite a record volume of new offerings in 1983 and a substantial volume in 1985, the total value of outstanding equities dropped by $83 billion in 1984 (about 4.5 percent) and by $63 billion in 1985, a unique event in the postwar period.[31] As one analyst commented, we are "decapitalizing significant portions of our industrial sector, which is disquieting at best in a capitalistic society." [32] And some note that stock retirements that are financed by debt are even more disquieting because:

> companies become more vulnerable to economic downturns or rising interest rates and
>
> this is likely to result in more bankruptcies during recessions or periods of high interest rates that will amplify their adverse effects.[33]

In short, there is concern that financing stock retirements with debt adds risk to the financial system and the economy as a whole. And even though stock retirements drove up prices and resulted in a higher volume of new issues in 1985, the gains for these issuers may be offset by the increased risk to the economy as a whole.

Mergers, takeovers and other stock retirement strategies may also have contributed to a significant shift in the ownership of stocks.

> As noted, stock holdings of individuals fell by $398.9 billion in the period 1978 through 1985 with more than half the decline—$205.5 billion—occurring in 1984 and 1985.[34]
>
> For the period as a whole, the decline in individual holdings and rise in holdings of institutional investors was greatest in years when merger exchanges for cash were largest.

These data suggest that the individual investor who sells stock in a takeover does not put his or her money back into the market. If this is so, why is it happening? Are the takeover battles eroding confidence in the market? And if that is the case, will the shift in stock ownership exacerbate or slow the rise in the dollar volume of takeover activity?

Innovative and derivative securities products. The explosive growth of derivative products based on financial assets (i.e., options, futures, options on futures, and stock index options and futures) is attributed to the perception that market uncertainty and volatility have required new methods of shifting or hedging risk, primarily by institutional investors. Certainly, the advent of such products has greatly expanded the markets in terms of both the overall volume of trading activity and the number and types of different institutional participants.

---

[31] See Part II, Chapter 4, Table 13a. There were also net retirements in 1978 and 1979 but the amounts were less than two-tenths of one percent of the aggregate value of outstanding stocks.

[32] Testimony of Michael C. Connor, Senior Vice President, Keefe, Bruyette & Woods, Inc., *Takeover Financing: Impact on Targets, Bidders, Financial Institutions and the Economy*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., April 23, 1985, p. 7 of written testimony.

[33] See statements of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, and John S.R. Shad, Chairman, Securities and Exchange Commission, quoted in Part II, Chapter 4.

[34] Part II, Chapter 4, Table 13a. Clearly, the impact of a decline in individual ownership on stock prices has been offset—at least temporarily—by a decline in supply due to retirements.

Although spokesmen for institutional investors, underwriters and the various exchanges extol derivative instruments' benefits in reducing risk,[35] others are less enthusiastic, arguing that:

> they may have increased market risk for individual investors, confused them and contributed to an erosion of their confidence in the markets;
>
> they add to volatility—particularly in cases where futures and options contracts on stock indices expire on the same day and precipitate frantic buying and selling of stocks;
>
> they "serve mainly to allow greater leverage to short-term speculators and arbitrageurs . . ." and, collectively, "contain considerable redundancy"; and [36]
>
> "The more 'derivative' an investment vehicle, the further away it takes us from the basic purpose of financial markets—capital formation—and the closer to speculation it becomes"; a result that "weakens the financial system and starves the industrial sectors." [37]

Like other financial innovations discussed here and elsewhere in this report, derivative products were developed in response to instability in the macroeconomic and financial environments. But the extent to which they may now augment the destabilizing effects they were devised to offset is a matter of greater concern. *And if the expanding markets for derivative instruments divert investment away from financing capital formation, that could result in a different kind of risk for financial intermediaries and the economy—a deterioration in credit quality. This risk may, in fact, be more serious than the kinds of risks that spawned the creation of derivative instruments.*

Mortgage-backed securities and the emerging market for securitized debt.[38] The spectacular growth in outstanding issues of mortgage-backed securities in the 1980s reflects one of the more significant changes in the structure and functions of financial intermediaries and markets precipitated by the rise in inflation and interest rates in the 1970s that resulted in the removal of interest rate ceilings on bank and thrift deposits. Despite the subsequent decline in inflation and interest rates, the removal of these ceilings perpetuated and increased depository institutions' vulnerability to interest rate risk and, thus, further reduced the attractiveness of holding the loans they originate in their portfolios. The alternative—the securitization of loan originations—has, therefore, become a more commonplace practice, extending beyond mortgages to CARs (collateralized automobile receivables) and sales of securities backed by pools of bank loans.

The securitization process benefits—

---

[35] See, for example, the various statements quoted in Part II, Chapter 4.

[36] Tobin, *op. cit.*, p. 13.

[37] James Balog, "New-Product Fever Will Subside Once Rates, Inflation Calm Down." *Financier*, Vol. VII, No. 8, August 1983, p. 56.

[38] Securitized debt differs from debt securities in that debt securities are issued directly by a single borrower and, in the case of nonfinancial corporate bonds, backed by tangible assets, while securitized debt is issued by financial intermediaries and backed by pools of loans to multiple borrowers.

depository institutions, by providing liquidity and freeing up capital to support a larger volume of loan originations than could be made if loans were retained on their balance sheets.

investors, by providing new products for diversification and—in some cases involving mortgage-backed securities—government guarantees or private insurance for medium- to long-term investments.

However, the proliferation and growth of securitized debt raises a number of concerns:

As the rate of increase in mortgage-backed securities (MBS) relative to corporate bonds suggests, the fact that government guarantees give MBS significant competitive advantages over corporate issues has tended to exacerbate the impact of Federal budget deficits in "crowding out" long-term corporate borrowers in capital markets.

The securitization process is likely to continue to undermine the role of the capital markets in financing capital formation in the business sector if securitized debt has the effect of adding to the supply of short- and medium-term issues.

It will increase risk because it "may tend to encourage sloppy procedures and inadequate loan evaluation as each party relies on others to investigate the loans thoroughly." [39]

In short, it encourages a drift "toward a financial system in which credit has no guardian"; where "the opportunity to disengage through securitization—loosens the link between creditor and borrower", and where "misconceptions about marketability" may lead to illusions about liquidity.[40]

The report concludes that these concerns about the rise in securitized debt and other developments in securities markets discussed in this chapter should be addressed and that, to do so, will require significant changes in regulatory strategies. While these developments are an outgrowth of other changes in financial structure and regulation, they constitute the most profound of these changes because they have rechanneled capital and credit flows and have contributed to an expansion of trading activity that is altering almost all relationships between institutions, borrowers and investors. As a result, their economic impact is likely to be equally pervasive and profound. The most obvious (and already visible) consequence is that the once-central function of capital markets in financing business capital formation is becoming a peripheral activity.[41]

---

[39] Statement of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System. *Expanding Securities Markets: The Economic and Regulatory Issues, op. cit.*, May 2, 1985, p. 239.

[40] Statement of Henry Kaufman, Executive Director, Salomon Brothers, Inc., *Financial Restructuring and Takeover Activities: Major Policy Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., June 5, 1985, Serial No. 99-21, pp. 385-386.

[41] For example:

over the 15 years since their introduction, the aggregate value of outstanding mortgage-backed securities has grown to $368 billion—half the value of total outstanding U.S. corporate and U.S.-issued foreign bonds—and total trading reached $2 trillion in 1985, more than the dollar value of trading in the world stock exchanges;

trading in stock index futures began in the spring of 1982 and on 28 days that year, the dollar volume exceeded that of the New York Stock Exchange (NYSE); and

the annual volume of contracts involving stock index options, foreign currencies and debt options traded on the Chicago Board Options Exchange (CBOE) in 1985 was equivalent to more than 100 percent of shares traded on the NYSE.

PART III: PROTECTING CUSTOMERS OF FINANCIAL INSTITUTIONS

A primary objective of financial regulation is customer protection. As discussed in the previous section of this report, all other major regulatory objectives are interrelated, implicitly or explicitly, with this central goal. But there are some strategies that are more directly targeted toward customer protection than are others.

The final section of this report examines two regulatory schemes that are explicitly intended to protect customers at the expense, if necessary, of the institution—the disclosure provisions of the Securities Acts that protect investors and the post-failure mechanisms such as deposit insurance, the Securities Investor Protection Corporation, the various state insurance guaranty programs and the Pension Benefit Guaranty Corporation—as well as regulatory schemes that are designed to ensure the soundness and competitive position of institutions as a means of protecting their customers and the communities they serve.

Although customer protection remains both the bedrock for confidence in the financial system and a central objective of financial regulation, the analysis in this and previous sections of the report suggests that:

customer protection has been weakened by changes in financial functions and products,

the consolidation of institutions and functions is undermining the rationale for differences in customer protection, and

restoring customer protection to previous levels—or even maintaining the current level—will require new regulatory strategies and a more uniform approach.

It also suggests that the restructuring effort must confront some very difficult problems. For example:

the risk to insurance programs and to confidence of continuing to insure financial functions that are integrated with functions that are not now insured or that have less coverage;

the risk to confidence posed by disclosure of the financial condition of individual depository institutions, and

the risk to insurance guaranty programs and confidence posed by permitting or encouraging a further proliferation of disparities between state and Federal regulation.

Chapter 1: Regulation to ensure soundness and fiduciary responsibility

This chapter examines the implications for customer protection of various disparities in regulatory strategies intended to ensure the soundness of financial institutions. In general, soundness regulation "includes restrictions on the competitive environment in which financial intermediaries operate, portfolio restrictions on both the asset and liability side, prohibitions on self-dealing and regulation of conflicts of interest." [42] But the particular focus here is on portfolio restrictions, and the disparities in regulatory treatment that have emerged as these restrictions have been relaxed.

As the rate of change in the financial services industry has accelerated, the blurring of financial functions and products has undermined the applicability of many protective strategies. Many new financial products appear to be functionally equivalent to the customer, although they have been introduced by institutions in different industry categories that are subject to different regulatory schemes and, therefore, offer varying degrees of regulatory protection. For example:

---

[42] Longstreth, *The FDIC Securities Proposal and Related Issues, op. cit.*, p. 87.

Money market mutual funds, cash management accounts and NOW accounts may appear similar in function, but differences in insurance protection and in fiduciary requirements may significantly affect the kinds and scope of protection afforded the customer.

Before the imposition of SEC Rule 3(b)9 requiring that banks engaged in discount brokerage activities register with the SEC, customers who chose banks to execute securities transactions because they trusted the institution may have been unaware that they were not receiving the full range of investor protections afforded by Federal regulation—e.g., SEC net capital requirements, requirements related to record keeping and the timely execution of transactions, and insurance coverage of their accounts by the Securities Investor Protection Corporation. They may have assumed that deposit insurance provides all necessary protection when, in fact, it offers no protection for these and other securities transactions conducted by banks.[43]

The proliferation of overlapping financial instruments and functions has been accompanied by a multiplication of regulatory conflicts, gaps and overlaps. As SEC Chairman John S.R. Shad has noted, regulatory jurisdiction over financial markets and institutions is exercised by 10 Federal agencies, by more than one agency in each of the 50 states and over 20 self-regulatory organizations.[44] The result is that:

banks, thrifts, securities firms and insurance companies compete under very different rules;

as their activities and products increasingly overlap, "competitive advantages increasingly turn on regulatory classifications rather than on the merits of financial products and services",[45] and

the current fragmented regulatory environment has increased pressure on regulatory agencies to relax, rather than improve, customer protection.

In response to increased evidence of regulatory disarray, some take the view that:

the current level of fragility within the financial system suggests there has been a significant erosion in regulatory standards for soundness and fiduciary responsibility, and

---

[43] As discussed in Part III, Chapter 1, other securities transactions conducted by banks that are not covered by deposit insurance include pooled investment management services. These services are not included in SEC Rule 3(b)9 and also are not subject to the protections of the Investment Company Act of 1940.

[44] Shad, *The FDIC Securities Proposal and Related Issues*, *op. cit.*, p. 15.

[45] *Confusion in the Legal Framework of the American Financial System and Services Industry*, 37th Report by the Committee on Government Operations, U.S. House of Representatives, 98th Cong., 2nd Sess., April 24, 1984, p. 2.

> while the few remaining state deposit insurance programs are being terminated, differences between Federal and state regulatory standards are now so extensive in some cases that they pose a significant threat to protective mechanisms provided at the Federal level—in particular, the adequacy of Federal deposit insurance funds and the effectiveness of the Federal Reserve's lender-of-last-resort facilities.

Others argue that:

> the various restrictions imposed by "soundness" regulation—on the competitive environment, on both asset and liability powers and on self-dealing and conflicts of interest—are anti-competitive, and
>
> efforts to revitalize the regulatory arsenal with new tools to address current problems constitute a trend toward "reregulation" that undermines the benefits of "deregulation".

By presenting evidence of the implications for customer protection of disparities between existing regulatory strategies and the realities of the marketplace, the purpose of this chapter is to point up the fact that *a major agenda for regulatory reform has emerged that requires immediate attention. But revisions of the regulatory framework that merely shift responsibilities from one regulator to another will accomplish very little if the objective is to ensure revitalization as well as clarification.* The content as well as the form of regulation must be addressed if, as the House Committee on Government Operations argues, "the federal agencies are to continue to oversee the safety and soundness of the financial system in a changed business, consumer, communications and technological climate".[46]

Chapter 2: Investor protection

Disclosure is the cornerstone of the regulatory scheme that governs securities markets. Information disclosure requirements are intended to ensure that investors can make informed decisions about the investments they wish to make. The basic philosophy underlying securities laws is that full disclosure, even of adverse information, will promote public confidence in the capital markets and thus encourage investments that finance economic growth.

This chapter outlines the legislative history of disclosure requirements and discusses their role in the current debate on financial restructuring. Arguments in favor of substituting market discipline for risk management schemes involving direct supervision and regulation tend to enhance the role of disclosure. But, many would argue:

> the skepticism that disclosure was intended to raise was never intended to apply to financial institutions—only to commercial enterprises, and
>
> the discipline that will be applied to financial institutions by investors and depositors acting on information about adverse developments can only work if these institutions are allowed to fail and investors and depositors are permitted to suffer losses.

---

[46] *Ibid.*, p. 6.

In short, the inherent conflicts between soundness regulation and disclosure suggest that:

> . . . [For] those two regulatory schemes to co-exist peacefully, side-by-side, would seem to require that each scheme apply to separate, non-competitive activities. No wonder the sparks fly as the financial services industry consolidates and as regulatory lines are crossed by participants.[47]

So far, the debate on extending disclosure requirements in response to financial restructuring has focused primarily on its impact on depository institutions. This chapter outlines the arguments of those who favor increased disclosure for depository institutions and those who oppose it. But the report concludes that:

> more extensive disclosure of information regarding nonbanking financial institutions may be required to take into account the consolidation of financial functions outside the banking system—the mergers of securities and insurance companies, for example, or the acquisition by these intermediaries of mortgage banking, commodities and other financial affiliates, or their links with nonfinancial companies—and
>
> the consolidation of financial functions will require greater disclosure of information about transactions between affiliated entities within a financial conglomerate so that investors can ascertain how the fortunes of one affiliate may affect the performance of others, and of the company as a whole.

But there are other important pressures affecting disclosure with which the SEC and Congress should also be concerned. The second half of this chapter discusses the growing internationalization of the capital markets and disparities in the regulatory schemes governing the various national markets involved in the movement toward integration. It suggests that increased linkage between U.S. and foreign securities markets will also require integration of different national regulatory mechanisms and standards to prevent erosion of disclosure, as well as enforcement, surveillance and other strategies of U.S. securities regulation that protect investors.

Chapter 3: Financial guaranty insurance programs

At the heart of the debate on financial restructuring are critical issues relating to the current effectiveness of the financial safety net and its future:

> At no time since their inception in the 1930s has the adequacy of the deposit insurance funds been more open to question. The FSLIC's reserves have fallen sharply, and while the FDIC's reserves have risen, it is widely recognized that they are too small to deal with the failure of a large institution or a systemic crisis.
>
> The potential threat to the deposit insurance and other insurance guaranty funds of a rising level of insolvent or illiquid institutions raises questions about the extent of the Govern-

---

[47] James C. Treadway, Jr., (then Commissioner, Securities and Exchange Commission), "A Seamless Web: Banks' New Activities and Disclosure", Keynote speech to the Third Annual Seminar on Securities Activities of Banks, New York, N.Y., September 29, 1983, pp. 5-6.

ment's overall exposure as the ultimate guarantor of the insured funds of customers of financial institutions.

This chapter focuses on the debate on proposals to reconcile inherent conflicts between financial guaranty insurance programs and market discipline. To establish the context for that debate, it describes the structures of, and differences in, protection afforded by the various programs—deposit insurance funds, the Securities Investor Protection Corporation (SIPC), state insurance guaranty funds and the Pension Benefit Guaranty Corporation (PBGC)—and explores some of the major issues and concerns that have emerged:

the possibility that changes in the functions of various intermediaries may have eroded the rationale for differences in protection;

that it may have become more difficult to "draw the circle" around those financial transactions and assets that should be protected to achieve the objectives of these programs;[48]

that the financial guaranty insurance programs now in place may not be able to cope with the current problems of the various financial services sectors; and

that the financial guaranty insurance programs may even be counterproductive in promoting stability in an increasingly deregulated financial environment.

The report's analysis of recent problems and crises suggests that these concerns are valid; that ripple effects stemming from the increased interdependence of institutions and markets pose a new threat to insurance guaranty programs. For example:

SIPC's resources clearly would have been inadequate to deal with crises in the silver and government securities markets in 1980 and 1982 that could have resulted in a number of failures and seriously weakened even well-managed securities firms if the Federal Reserve had not intervened promptly and aggressively to prevent ripple effects.

As the FDIC's 1983 report to Congress predicted (and the near-failure of Continental Illinois in 1984 revealed), the relatively limited size of the deposit insurance funds in relation to total deposits—a ratio of 1.3 percent for the FDIC and 0.7 percent for the FSLIC at year-end 1984—and the statutory limits on their authority to borrow from the Treasury inhibit their ability to deal with ripple effects in crises of this magnitude.

It is therefore likely that the Continental Illinois solution—providing capital support after a substantial run-down in assets has taken place—will be used again to avert the failure of a large institution that could precipitate a chain reaction affecting other intermediaries, despite the degree of government intervention (virtual ownership) that it entails and the fact that it negates the "free market" model of regulation favored by many financial institutions and their regulators.

Weaknesses in the state guaranty programs for insurance companies are also increasingly a source for concern:

Some of the weaknesses are inherent in the structure of these funds—the fact that most levy assessments after problems emerge and thus impose additional strains on companies in periods when the industry as a whole may be experiencing adverse conditions.

---

[48] Longstreth, *Securities Proposal and Related Issues*, *op. cit.*, p. 81.

Others stem from weakness in the structure and regulation of the industry itself—particularly the absence of regulation of reinsurance.

There is a growing recognition that reinsurance, once a trusted method for minimizing risks to primary insurers, may now be their Achilles heel. Because reinsurance companies rarely deal directly with policyholders, they have been viewed as an industry "involving sophisticated professionals far removed from the consuming public".[49] But this rationale for their exemption from regulation has been undermined by:

the rush of newcomers into the industry in the 1970s;

a rash of scandals and losses in the 1980s; and

the fact that neither the regulators nor the primary insurers themselves know the identity of all the players since a reinsurance company may pass off much of the risk to yet other reinsurers that, in turn, can cede to still others, creating a long chain that may be impossible to unravel in the event of an insolvency.

Complacency about financial arrangements and transactions between supposedly sophisticated professionals involving other industries has been shaken as well. This has led to proposals to:

regulate reinsurance;

tighten the regulation of banks' international activities;

regulate the government securities market, and

impose margin requirements on purchases of high yield bonds issued by shell companies that use stock acquired in takeovers as collateral for borrowings.

But these and other proposals to expand regulation to areas not previously covered are being offered at the same time that proposals to loosen existing regulations and expand permissible activities are being implemented or considered. *The contradictions apparent in these developments reflect the basic conflict between the movement toward deregulation, which would release the free play of market forces by relying on disclosure to raise skepticism, and a regulatory scheme that relies on financial insurance guaranty programs to allay doubts.*

Attempts to reconcile the inherent conflicts between increasing competition and preserving customer protection have prompted a number of proposals for modifying the deposit insurance programs, including:

risk-related insurance premiums;

reducing the level of coverage;

an increased role for private insurance coverage;

increased capital requirements in general and/or in relation to differences in portfolio risk; and

combining the thrift and bank insurance funds.

---

[49] John C. Gurley, quoted in "Regulation of Reinsurance in the United States", *National Underwriter*, August 26, 1983, p. 53

While all are perceived as entailing significant costs that could undermine expected benefits, they nevertheless point up the consensus view that:

protecting depositors remains absolutely necessary to maintain confidence in depository institutions, and

bank runs pose a potent threat to economic stability if the public loses confidence in banks or in the deposit insurance system.

But the reports submitted to Congress by the FDIC and FSLIC also make clear the agencies' belief that the system is less stable than in the past and the risk to the deposit insurance funds greater. The behavior of sophisticated investors indicates that at least that segment of the public has less confidence in soundness regulation, if not in the willingness of the government to honor its insurance obligations. For example:

By placing deposits in several institutions so that all their total deposits are insured, large investors can exploit a higher level of systemic risk to earn higher returns at the expense of the deposit insurance agencies.

This practice has introduced one element of market discipline into the system: unsound institutions generally pay a higher return to attract funds.

But unsound institutions can now attract a larger volume of insured deposits through brokers and that increases their propensity to take risks and the total amount of insured deposits that are at risk.

Sophisticated investors not only undermine the deposit insurance programs as presently constituted, they undermine proposals for introducing increased market discipline as well:

Increased disclosure can only assist their efforts to identify problem institutions that will pay a higher return.

Risk-related insurance will do the same.

Thus these mechanisms will tend to perpetuate the incidence of parcelling out deposits across a wider number of insured institutions and the increased cost of funding for unsound institutions without reducing risks to the insurance system.

The proposal for increasing the deposit insurance agencies' authority to borrow from the Treasury could also have perverse effects:

It would reaffirm the belief that the government will continue to protect depositors in unsound institutions.

And more of the costs of financial instability would be borne by taxpayers, less by banks.

Theoretically, the proposal for higher capital ratios funded by subordinated debt offers the best hope for devising a strategy that increases market discipline and discourages risk without abandoning or significantly reducing deposit insurance coverage. It has appeal because large, sophisticated investors—the primary source for subordinated debt—would incur significant risks without being able to withdraw funds and cause a run on the bank. But it could significantly increase the cost of capital for banks and simultaneously put profits under pressure by limiting their leverage.

In summary, the level of instability in the financial system and risk to the financial guaranty insurance programs is widely acknowledged. Both proponents and opponents of deregulation warn that these levels will rise if no action is taken. But views on how to reduce risk remain highly polarized:

> Some argue that partial deregulation has eroded profits, particularly for banks, and that additional deregulation (e.g., less soundness regulation and increased competitive opportunities resulting from an expansion of permissible activities) will augment profits and lower the level of risk.
>
> Others doubt that further deregulation will increase profits without augmenting instability and risk. They advocate limiting permissible activities while improving soundness regulation.
>
> In the middle are those who believe that deregulation has and will create problems that require a fundamental reexamination of differences in financial functions and regulatory schemes; that what is needed is neither less nor more regulation, but more *appropriate* regulation.

This report takes the latter view. It finds that changes in financial structure have tested the applicability of existing regulatory strategies and may have eroded their ability to maintain stability and contain risk. As the summary of previous chapters suggests, objectives other than customer protection have been equally affected. And even efforts to preserve customer protection may be counterproductive if they fail to take into account the importance of other objectives of financial regulation.

For example, the report calls attention to the fact that a unique experiment in the history of this or any other financial system was undertaken with the decision to permit payment of market rates of interest on *insured* short-term financial assets. The concerns motivating this decision were very narrow. There was no attempt to assess its impact on the traditional missions of the affected institutions (banks and thrifts) or on the economic functions of the financial system as a whole. As a result:

> depository institutions find it increasingly difficult to channel their funds into productive uses, while
>
> borrowers who might use funds to create jobs and increase economic activity find it increasingly difficult to obtain funds under terms that would ensure that they could be used productively.

Again, these outcomes increase instability and risk and thus undermine the intended objective: customer protection.

This report offers a suggestion for changes in insurance coverage that may address this and other concerns about the ability of insurance guaranty programs to protect customers.[50] But the primary objective is to point out that:

> there is already abundant evidence that solutions that address only one problem or one sector of the financial services industry increase, rather than reduce, instability and risk;

---

[50] Part III, Chapter 3 and Appendix D outline suggested changes in the insurance guaranty programs that would provide unlimited coverage for non-interest bearing transactions accounts issued by depository institutions, and limited coverage of savings based on the aggregate amount of an individual's investment in debt obligations issued by regulated financial institutions

changes in financial structure and regulation must be considered in the context of their impact on both the financial system and the economy as a whole, and

Congress must therefore take an active, rather than reactive, role in formulating public policy for financial restructuring, to preserve the stability and soundness of the system, promote public confidence and facilitate economic growth.

BLANK PAGE

PART I: THE FRAMEWORK FOR FINANCIAL STRUCTURE AND REGULATION

BLANK PAGE

CHAPTER 1: THE CURRENT DEBATE ON REGULATORY POLICY

INTRODUCTION

Over the last two decades, the principal differences in views on the role of regulation in financial markets have remained unchanged. Those who believe that market forces alone are sufficient to ensure competition and efficiency, and that relying on investors' perceptions of risk will force institutions to maintain sound practices build their case on the views and findings of participants in a variety of commissions and studies that have dealt with issues of financial regulation.[1] Others doubt that market forces can do the whole job—particularly in ensuring soundness and preventing conflicts of interest and the concentration of financial resources—and believe (with other participants in these earlier commissions and studies) that maintaining confidence in the financial system requires government intervention to minimize the risks to savers and investors that can result from unsound or fraudulent practices.

There are also different views of the role of regulation in allocating capital and credit. On the one hand are those who advocate neutrality; on the other are advocates of interventionist policies that have as their purpose the allocation of credit to specific sectors. Somewhere in the middle are a number of analysts who argue that a change in the process of intermediation can influence the level and structure of interest rates. This implies that an allocative function is implicit in financial structure and that—whether influenced predominantly by market forces or the intended or unintended effects of regulation—a financial system that channels credit to all borrowers in a completely neutral fashion is not the norm. Some argue further that these influences have significant economic effects—that changes in financial structure and regulation alter the distribution of savings, causing shifts in the allocation of capital and credit and, in turn, in the level and composition of economic activity.

Another persistent theme has been the need to rationalize the very complex regulatory structure characterized by duplication at both the Federal and state levels and thus reduce the regulatory burden and improve its efficiency. The fourth major theme in earlier discussions focused on the advantages and disadvantages of expanding the range of services that depository institutions could offer. That issue, too, has persisted.

---

[1] Earlier efforts leading to recommendations for reform or rationalizations of various aspects of financial structure and regulation include the Hoover Commission (1949), the Commission on Money and Credit (1961), the Hunt Commission (1971) and the FINE (Financial Institutions and the Nation's Economy) Study (1975).

THE ISSUE OF FINANCIAL CONSOLIDATION

Until the 1970s, the segregation of financial institutions and functions mandated by the Glass-Steagall Act and other financial legislation of that period remained relatively intact. The primary function of securities firms and exchanges was to channel long-term financial investment into capital formation. The primary function of the insurance industry was the assumption of risk for both individuals and companies. But insurance companies also performed a financial function like that of other institutional investors that manage pension funds, trust accounts and other pools of savings, by investing their huge financial resources in long-term financial assets that fund capital formation. The traditional role of commercial banks was the use of short-term deposits to provide short- and medium-term loans for working capital. Thrifts were repositories for household savings used to finance long-term, fixed-rate mortgages for housing, and credit unions used household savings for consumer lending.

Each of these financial sectors continues to perform these functions. But most have added the functions of other sectors as well. The breakdown of barriers between financial functions and products in the 1970s and 1980s has been widely recognized and discussed. As documented elsewhere in this report,[2] the movement of depository institutions into other financial activities at home and abroad and a symmetrical movement by other financial intermediaries and commercial conglomerates into depository activities has been extensive. And the extent and scope of changes that have already occurred have provided the focus for the current debate on financial restructuring: the need to equalize competitive opportunities among financial institutions by establishing a so-called "level playing field."

Most participants in the debate agree that the expansion of services which has already taken place has increased, rather than reduced, so-called "competitive inequities." [3] But there is little agreement on how this problem should be resolved. Because of their unique role and competitive advantages, some argue that a further expansion of nonbanking activities of depository institutions should be prohibited. Others favor a further expansion of depository institutions' nonbanking activities through separate affiliates and favor permitting other financial institutions to own banks. But proponents of this position differ on the types of activities that should be commingled with banking, how affiliation should be structured, and whether or how much a depository institution should be permitted to lend to its affiliates. Still others favor allowing banks to engage directly in any financial or commercial activity on the grounds that other financial institutions and nonfinancial conglomerates have already moved into depository activities.

---

[2] In the following chapter (Part I, Chapter 2), in Part II, and in Part III, Chapter 1

[3] Stephen J. Friedman offered examples of existing competitive inequities and underscored their importance in a June 5, 1985, letter to the Subcommittee on Telecommunications, Consumer Protection and Finance:

> The inequity arises from the need of financial institutions to respond to market forces. For example, when the yield curve is inverted, institutions with long-term liabilities, such as insurance companies, must find a way to give short-term returns to policyholders. Those with long-term assets, like thrifts, must find a way to receive short-term returns. Often regulatory structure stands in the way. Banks, with short-term assets and liabilities do not have that problem. Similarly, when banks and insurance companies find themselves competing for the same savings dollar, it makes a difference that insurance companies are not subject to geographical restrictions.

[Note.—it also makes a difference that the liabilities of insurance companies are not Federally insured.]

> These are not merely interindustry quibbles, for they affect the ability of institutions to compete for capital and to offer services on the basis of price and quality. The regulations alter capital flows, and they ought not do so except in the pursuit of sound regulatory objectives.

As this rough outline of the major positions suggests, the current debate on financial structure and regulation differs from earlier debates because of the degree of restructuring that has been proposed and has already occurred. The issues now are the appropriateness of permitting *all* financial intermediaries to engage in *any* activity of a financial nature—in effect, ratifying the trend toward the financial supermarket by erasing all existing barriers between institutions, functions and products—and the issue of defining the appropriate degree of involvement of nonfinancial companies in providing financial services.

REORGANIZING THE REGULATORY FRAMEWORK

Pressure for reorganizing the regulatory framework has intensified as a result of the scope of actual and prospective changes in financial structure. The difference between current and past debates on this issue is a matter of degree. Proposals for consolidating or rationalizing the regulation of depository institutions were discussed with some frequency in the 1960s and 1970s. But the rapid development of new communications and computer technologies in the 1970s has changed the focus of current proposals. Widespread use of innovative technologies has blurred distinctions between the products and functions of financial institutions. As a result, differences in regulatory treatment are perceived as having a greater effect on competitive opportunities not only among depository institutions—the major issue in earlier debates—but between these and other financial institutions.

Like the debate on financial restructuring, the debate on regulatory restructuring has focused on competitive equality and the need to establish a "level playing field". But change is also needed to preserve the basic goals of regulation. The consolidation of financial functions has tended to undermine the ability of individual regulatory agencies to adequately supervise institutions within their jurisdiction as these institutions move into activities that are currently supervised by other regulators, or not supervised at all.

Some argue that the solution to the problem is to regulate by function. This means that a given financial institution would be subject to regulation by several Federal regulators rather than by one, with each regulator exercising the regulatory responsibilities that apply to a given activity. The alternative would be a further duplication of regulatory responsibility among existing agencies if the announced goals of competitive equality for multi-functional financial institutions and maintaining an adequate level of supervision are to be achieved.

To some extent, a shift toward functional regulation is occurring. For example, the Securities and Exchange Commission has asserted responsibility for regulating the newly authorized discount brokerage subsidiaries of banks (although the banks deny its authority to do so). But the SEC does not regulate banks' trust and pension funds—which, as a result of the pooling of funds for investment from multiple accounts, have many of the characteristics of more closely regulated mutual funds—nor many of the new securities activities that have been undertaken directly by banks. The fact that regulation of all banks' current securities activities has not been shifted to the SEC does result in a duplication of SEC responsibilities by bank regulators.[4] Moreover, since the expansion or changes in these activities have been authorized, in most cases, by regulation rather than by law, the way they are regulated differs from the way that similar activities of institutions supervised by the SEC are regulated and often results in competitive advantages for banks. Thus a case for the need for regulatory reorganization on competitive grounds could be (and has been) made, even if no further changes in financial structure were to occur.

Another recurrent theme in the debate on the regulatory framework is the role of state versus Federal regulators. States have traditionally had a major role in regulating financial services. For example, states have exclusive jurisdiction in regulating insurance companies and those finance companies that are not controlled by bank holding companies. They have the prerogative of defining usury by determining maximum levels of interest rates on consumer loans and defining branching opportunities for all banks. They also have a duplicative role in regulating state chartered depository institutions and issues of securities within the state.

As discussed in the next chapter, the more relaxed attitude of state regulators toward the activities of depository institutions—in particular, their securities activities—was an important factor in shaping the Glass-Steagall separation of banking and securities activities. From the 1930s until the 1970s states generally played a smaller role in influencing financial structure, although they strongly resisted sharing their prerogatives to charter and regulate the operations of foreign banks with Federal regulators as was eventually required by the International Banking Act of 1978. Recently, however, some states have become leaders in pressing for structural innovation. In some cases, the changes they have inaugurated or proposed have had national implications.[5] At the extreme, it is feared that, in the absence of legislation to preempt their efforts, the Federal regulatory structure could be significantly undermined because incentives for depository institutions to remain under the Federal regulatory umbrella have been eroded.[6]

---

[4] Bank regulators are also responsible for determining the amount of information that banks are required to disclose to actual and prospective stockholders. Bank holding companies, on the other hand, are required to file registration statements and quarterly reports with the SEC. The degree of disclosure for banks within a holding company is generally considered to be greater.

[5] These developments are discussed in Part III, Chapter 1.

[6] The first instance in the process of erosion occurred in 1913 when the Federal Reserve Act rescinded the exclusive power of national banks (in effect from 1864) to issue notes (paper money) and gave that power to the Federal Reserve banks. (National banks were encouraged to redeem their notes over a 20 year period by being allowed to repurchase government bonds backing the notes at par until 1935 when the circulation privilege expired and the last of the bonds backing national bank notes were called.) The second instance occurred in the late 1930s when Congress waived the requirement in Glass-Steagall that all insured banks be members of

Continued

These developments also contribute to heightening pressures for regulatory reform and add new urgency to the century-old debate over the advantages and disadvantages of maintaining both a Federal and state framework for financial regulation.

ELIMINATING SPECIAL TREATMENT FOR BANKS

In the United States, laws and regulations governing depository institutions have carried the burden of determining financial structure.[7] This is illustrated by the moratorium and restructuring proposals introduced in 1983, 1984, and 1985, all of which used banking and thrift laws to define prohibited activities. The burden placed on this body of law and regulation reflects the special role that depository institutions have played throughout recent history as the intermediaries through which payments are made. Even more recently they have assumed other responsibilities, including—in 1913 in the United States—the responsibility to act as conduits for monetary policy. The unique role and responsibilities of depository institutions have resulted in special treatment that creates competitive advantages and disadvantages as these institutions move into more direct competition with other financial intermediaries.[8] Many elements of this special treatment—deposit insurance, reserve requirements, the degree of direct regulation and supervision, and exemption from disclosure, for example—are under pressure. In fact, proposals to alter or eliminate the special treatment accorded depository institutions are a very important part of the effort to deregulate the financial services industry.

There is general agreement that, as depository institutions move into non-traditional activities, justification for their exemption from disclosure, or from SEC regulation of all their securities activities, is weakened. To continue these exemptions would exacerbate the competitive advantages and disadvantages experienced by banks vis-a-vis other financial institutions.[9] There is also agreement that the effectiveness of bank regulation has been eroded because of the inability of regulatory authorities to supervise a broader range of activities. As a result, confidence in the ability of regulation alone to ensure soundness has been undermined.

---

the Federal Reserve System. Finally, the Depository Institutions Deregulation and Monetary Control Act of 1980 removed incentives for Federal Reserve membership by providing that all depository institutions issuing transactions accounts be subject to reserve requirements and have access to Federal Reserve discount and other facilities. Thus all banks now share the same costs and receive the same benefits as do member banks.

[7] As discussed below, the Securities Acts have important purposes other than structural definition. The 1975 Act mandating the development of a national market is an example of a structural change implemented under amendments to the Securities Acts that has fundamental implications for the way in which securities are traded but has limited implications for other asset markets.

[8] For purposes of clarifying the debate on competitive advantages, it might be useful to note here that deposit insurance is perceived as a factor that lowers the cost of funds and, given government backing for insurance funds, as a subsidy. On the other hand, the requirement that depository institutions maintain non-interest bearing reserves with Federal Reserve banks raises their cost of funds and is perceived as a special franchise tax which only depository institutions bear because of their role as conduits for monetary policy.

[9] Banks are also exempted from intrasystem managerial locks (the requirement that different segments of a combined enterprise be under separate management) under the Clayton Act (Robert Charles Clark, "The Regulation of Financial Holding Companies", *Harvard Law Review*, vol. 92, February 1979, pp. 803-804). As banks have moved into nonbanking activities through affiliate relationships, this exemption has created increased opportunities for self-dealing. It also enhances the ability of banks to consolidate services and provides significant advantages in competing with financial networks owned by other financial or nonfinancial enterprises.

As discussed, functional regulation has been proposed as one solution to the problem. Another is to subject depository institutions to the same degree of disclosure as other financial and nonfinancial corporations and thus permit market forces to play a larger role in financial regulation. It is argued that investors' and savers' decisions based on more complete information about the activities and condition of financial intermediaries would be highly effective in equalizing competition (by limiting or increasing opportunities to attract funds) and thus would serve as a viable substitute for soundness regulation in restraining unsound practices.

Some argue, however, that the soundness of a given institution is irrelevant if the public loses confidence in the system. Bank runs affect sound and unsound institutions alike. Relying on market forces to discipline banks necessarily increases skepticism and requires that banks be permitted to fail. As the number and social costs of bank failures rise, confidence in the system as a whole will decline.

The risks posed by banks' entry into non-traditional activities are also seen as threats to soundness and public confidence. Many doubt that banks can be effectively insulated from these risks merely by requiring that they engage in nonbanking activities through separate subsidiaries or affiliates. They point out that banks have already experienced serious problems as a result of their involvement in non-traditional activities—acting as advisers for Real Estate Investment Trusts (REITs) and engaging in less closely supervised and regulated foreign exchange and international lending operations, for example—and that, as in the REIT case, problems arose because banks bailed out their affiliates.

As these views suggest, balancing competition and soundness is a central issue in the debate on financial restructuring. The advantages and disadvantages of the various changes proposed to resolve the apparent incompatability between these goals are discussed at greater length in subsequent sections of this report.[10]

THE LIMITS TO DEREGULATION

The debate on the appropriate role for market forces in regulating depository institutions points up the fact that the current trend toward deregulation is relatively limited in scope. Most of the focus, as in the past, is on depository institutions. Although some advocate a less active role for the SEC, it has not been suggested that the Securities Acts be rescinded or the SEC dismantled. No one has proposed a relaxation of disclosure requirements or enforcement efforts or capital and reporting requirements for securities broker-dealers, or a weakening of investment restrictions for insurance companies or examinations and other safeguards that protect policyholders. In fact, state insurance regulators propose to increase their budgets and personnel and extend surveillance to unregulated areas of the industry. And even with respect to depository institutions, there is pressure on states to upgrade examination and supervision procedures and, at the Federal level, pressure on banks and thrifts to raise capital-to-asset ratios as well as regulatory proposals and decisions to offset potential risks stemming from more liberal state policies governing investments and powers.

---

[10] See Part II, Chapter 2 and Part III

There is still a consensus view that insurance guaranty programs—for securities firms and insurance companies as well as depository institutions—are the cornerstone of confidence in the financial system.[11] There is no less agreement on the importance of preserving the Federal Reserve's leverage in conducting monetary operations and its role as lender-of-last resort. Some argue, in fact, that the lender-of-last-resort function—like insurance guaranty programs before—should be extended to include all financial intermediaries.[12] As these views suggest, almost all participants in the debate advocate a continued, major role for government in the financial system.

This does not mean that change will not take place or that proposals for change should not be weighed carefully to ensure that protection for savers and investors is not weakened. But neither the public nor the majority of financial institutions themselves are willing to return to the days of wildcat banking and wholesale stock manipulation. Improvements in the regulatory environment that were the result of the 1930s reform legislation are taken for granted. Moreover, the government's role in assuring those improvements is also taken for granted. While there is room for a larger role for market forces in the regulatory process, it should be understood that its scope is limited by the pervasiveness of the government's role in financial regulation compared with the past, and by the government's extensive involvement in credit programs as well.[13]

Financial deregulation in the current context means primarily knocking down the walls that have separated financial functions and reorganizing the regulatory framework to provide more appropriate and effective regulation—including a greater degree of disclosure for depository institutions. Interest rate deregulation is a *fait accompli* and product integration is well underway. Thus, as a spokesman for one major bank testified: "It is not that we feel deregulation is needed, it is more rational regulation." [14]

As these remarks suggest, "deregulation" is the wrong word. The use of the term "deregulation" does not have the same meaning for financial institutions as for the airline, telecommunications, or trucking industries. Nevertheless the justifications for relaxing regulatory restrictions—to increase competition and lower price, to improve entry and exit and provide more information for competitors and consumers—are the same. If these were the only concerns applicable to financial services, then deregulatory efforts comparable to those for other industries would be appropriate. They are not, so it is useful to explore why financial services differ from services provided by nonfinancial companies and what implications this has for the role of regulation.

---

[11] A comparison of current insurance programs for depository institutions, securities firms and insurance companies is provided in Part III, Chapter 3, of this report.

[12] See Part II, Chapter 2 for a discussion of this issue.

[13] The Government's role in financial markets is described in Part II, Chapter 1.

[14] Testimony of Roberto Mendoza, Executive Vice President, Morgan Guaranty Trust Company, *Expanding Securities Markets: Regulatory and Economic Issues.* Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, May 2, 1985, Serial No. 99-21, p. 332.

THE IMPACT OF FINANCIAL STRUCTURE AND REGULATION ON ECONOMIC ACTIVITY

It is widely acknowledged that changes in monetary policy and the macroeconomic environment result in changes in financial structure. The reverse is equally true. Few would deny the existence or importance of the link between the financial system and the real economy, or that effective monetary policy actions depend on that link. To many economists and market participants it is obvious that:

> . . . the effect of any action by the monetary authority depends on the interaction between the central bank's action and the complex financial structure which links the central bank to the expenditure decisions of households, businesses, and government.[15]

And if "financial structure makes a difference," it is equally obvious that

> . . . changes in the powers of financial institutions, in their competitive relationships, or in the types of financial instruments in use, will surely influence the cost and availability of credit to different types of borrowers.[16]

A more recent analysis in support of the role and importance of financial structure in determining links between the financial and real sectors was offered in testimony before the Subcommittee on July 14, 1983, by Professor Benjamin M. Friedman:

> This different behavior by financial institutions presents an opportunity for financial regulation either to impede or encourage the supply of long-term funds in our financial markets, and therefore either to impair or alternatively to encourage American capital formation.
>
> The question that then arises is whether these effects can be quantitatively important. In other words, can they be important enough to matter as a focus of policy at the national level? On the basis of research which was published just last year, I believe that the answer is "Yes." Such effects not only exist but are quantitatively large, large enough to be important from a public policy perspective.
>
> * * * * *
>
> The main point, in summary, is that financial regulation can importantly affect saving patterns in ways that have

---

[15] Barry Bosworth and James S. Duesenberry, "A Flow of Funds Model and Its Implications," *Issues in Federal Debt Management*, Proceedings of a Conference sponsored by the Federal Reserve Bank of Boston, June 1973, p. 42.

[16] *Ibid.*, p. 42. Bosworth and Duesenberry provide evidence in support of this view and argue for a holistic approach in examining the effects of structural change. They argue, for example, that "The side effects of the proposed change can only be analyzed by considering the reactions in a whole set of closely related markets"; that "No analysis of the effects of changed S&L powers will be complete unless it deals with the whole system. Piecemeal analysis will only kick the problem around until it gets lost." (*Ibid.*, p. 42).

> potentially large implications that extend far beyond the financial markets themselves.[17]

Not all analysts agree with that view. Testifying in favor of "allowing the continued unwinding of the regulatory mechanism" [18] at the same hearing, Dr. Alan Greenspan stated:

> Owing to the complexity and confusion engendered by recent changes in financial structures, it is desirable to review the impact of financial intermediation on savings, investments and economic performance. It should be pointed out first, however, that the forces that drive capital investment in this country are far more potent than the possible impact of change in our financial structure.[19]
>
> * * * * *
>
> . . . There has been a dramatic decline in both the average economic life of capital investment on the one hand and the total GNP on the other.
>
> That is, in my judgment, almost wholly, if not wholly, explained by the issues of inflation, risk, and the level of uncertainties about the future.
>
> I find little evidence that the structure of our financial institutions is a major element in that.[20]

Dr. Greenspan agrees that the "flows of funds are somewhat different" than in the past [21]—a primary indicator for those who argue that changes in financial structure alter savings flows and, thus, the distribution of capital and credit. He also agrees that government interference in the form of regulation and subsidies can influence intermediaries' ability to attract funds. But he advocates removing what he views as restraints on market forces (such as insurance guaranty funds).

When opinion diverges so widely, making policy decisions obviously becomes more difficult. But policy makers must deal with the world in which they live—with markets that are not (and are not likely to become) perfectly free at home or abroad. Therefore, the possibility that changes in financial structure and regulation affect economic activity cannot be ignored. And, if financial structure and regulation have as much influence on economic growth and on spending decisions that determine the level of consumption and investment as some analysts think is the case, the needs of public policy require that considerations other than competitive equality among various financial institutions be taken into account in constructing the appropriate scenarios for change. Moreover, it is important to note that while current concerns focus on the allocative effects of tax incentives and on budget deficits as the primary constraint on future growth, monetary and financial instability were seen as more important sources of problems for the economy throughout the 1970s than fiscal policy.

---

[17] Testimony of Professor Benjamin M. Friedman, Harvard University, *Future of Financial Markets*, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, July 14, 1983, Serial No. 98–42, pp. 203–204.

For a more complete exposition of Dr. Friedman's argument, see "Effects of Shifting Saving Patterns on Interest Rates and Economic Activity", *The Journal of Finance*, Vol. XXXXVII, March 1982, pp. 37–62.

[18] Testimony of Alan Greenspan, Chairman and President, Townsend-Greenspan & Co., Inc., *Ibid.*, p. 252.

[19] *Ibid.*, p. 253.

[20] *Ibid.*, p. 258.

This second statement by Dr. Greenspan was in response to Professor Friedman's comments. Dr. Friedman said:

> I was surprised that while I agreed with Alan Greenspan's analysis, it led him to a conclusion that I did not recognize.
>
> I agreed when he explained that we could manage in an economy without any financial intermediaries but that we do not live in one. I also agreed when he went on to say that our exploitation of those financial intermediaries that we do have helps our economy in its saving and investment process, and therefore changes the nonfinancial economic outcomes that we have.
>
> I would have thought that the implication of this line of argument is that greater reliance on at least some of these intermediaries would further encourage the economy's saving and capital formation process. One could always imagine that the market is simply choosing on its own, without any interference from the Federal Government, which financial intermediaries to use, but I do not think that is a good description of the world in which we live either (*Ibid.*, p. 256).

[21] *Ibid.*, p. 257.

The view that the effectiveness of monetary policy depends on its interactions with the financial system suggests that one of the criteria that must be taken into account in a constructive effort toward financial restructuring is whether or not the leverage afforded the central bank in implementing policy is strengthened or weakened by a given structural change.

Another issue suggested by these views relates to the role of regulation. Whether intended or unintended, regulation clearly affects the allocation of credit wholly apart from the exercise of monetary policy by the Federal Reserve. Recognition of that fact and of its effects on the economy is needed if the regulatory framework is to play a constructive role in public policy. Again, proposals which focus only on ensuring equality of competitive opportunities for financial institutions could have unintended adverse effects on economic performance.

Finally, the view that an allocative function is implicit in financial structure and regulation undermines the credibility of the "free market" model for financial regulation. Such a model implies that deregulation will ensure neutrality in investment and credit decisions. There is little historical evidence to support that assumption and the limited potential for deregulation in the future suggests that it is an assumption that is unlikely to be fully tested. As discussed elsewhere in this report,[22] the persistence of the belief in "free" financial markets is difficult to explain in the face of the evident effects of monetary, regulatory and tax policies and more than 300 federal credit programs on savings and credit flows. Given so extensive a role by government and the complexity of U.S. financial structure, relying on market forces to produce optimal investment and credit decisions seems overly simplistic.

So far, the economic implications of financial restructuring have been given short-shrift in the public debate. As amply demonstrated in its record of hearings,[23] Members of this Subcommittee believe it should be the primary focus. The position of its chairman and many Members of both parties can be summed up in the question: If we don't know what changes in financial structure and regulation mean for the economy, why are we making them? For the most part, this question has been left unanswered by witnesses who argue that it's too broad; that the debate should continue to focus on well-trodden ground—the issue of competitive equity for financial institutions and sectors.

---

[22] See Part I, Chapter 3, Part II, Chapters 1 and 4 and Appendix A.
The analysis of various regulatory strategies, tax policies and Federal credit programs that increase the flow of funds to housing provides evidence of the reality and extent of allocative activity on the part of the U.S. government.

[23] See Appendix C for a summary of these hearings.

While it is well beyond the scope of this report to provide answers to this question, it will attempt to provide background for future discussions of the role of the financial system in the economy. By exploring the underlying economic objectives in financial structure and regulation in the past, it is hoped that this effort will encourage the kind of debate that takes into account the links between financial structure and regulation and economic activity.

BLANK PAGE

Chapter 2: Issues in the Evolution of Federal Regulation

INTRODUCTION

For more than a century, Congress has been predominantly concerned with the soundness and stability of the Nation's financial institutions. Now, competition among the various institutions and sectors is advanced as a preeminent goal of financial regulation. A certain amount of tension naturally exists between these two public policy goals. The U.S. experience of periodic bank failures, financial crises and economic downturns tended to swing the pendulum in the direction of safeguarding the financial system.[1] Only more recently, after a long trend of economic and financial stability, has concern with competition among financial institutions gained prominence.

Since the late 1800s, Congress has sought to meet the objectives of preserving the soundness of the financial system by separating the business of commercial banking from unrelated economic and investment activity. Financial compartmentalization in the United States has been challenged repeatedly since the turn of the century; however, the barriers have tended to be restored. This long-established tradition of separation reflects both U.S. historical experience and the influence of English financial structure.

The English model of financial structure separated investment and commercial banking in the belief that investment banking is "risky" and commercial banking is the conservative use of "other people's money" to invest in "self-liquidating", short-term loans.[2] The "commercial loan theory of banking", upon which the English system of functional separation was based, held that if banks limited their lending activities to loans for bona fide commercial purposes, the economic system would adjust to the "needs of trade." Although periodic economic depressions were unavoidable, it was believed that this system would prevent chaos and panic in the financial system, and that the "real savings" of the economy should be the logical source of funds for permanent capital investment, not bank deposits which are transactions accounts. To a great extent, what was meant by "sound banking practice" in the United States in the period up to (and including) the 1930s, was simply acceptance of English banking standards.[3]

---

[1] Arnold W. Sametz, Michael Keenan, Ernest Bloch, Lawrence Goldberg, "Securities Activities of Commercial Banks: An Evaluation of Current Developments and Regulatory Issues", *Journal of Comparative Corporate and Securities Regulation, II*, 1979, p. 155.

The 1929 stock market crash is only the most severe in a series of financial disruptions, e.g. the panic of 1873 and the panic of 1907 (which led to the enactment of the Federal Reserve Act).

[2] The "German model", in contrast, consciously mixed investment banking and commercial banking, as discussed below.

[3] Edwin J. Perkins, "The Divorce of Commercial and Investment Banking: A History," *The Banking Law Journal*, Vol. 88 (June 1971), p. 485.

However, the banking system that evolved in this country in the late nineteenth century did not neatly conform to the English model on which it was conceptually based. A major impediment was the dual banking system, "with state and national chartering agencies in competition to offer more 'attractive'—meaning lenient—provisions." [4] A brief review of the history of financial regulation in the United States and the historical debate of the issues offers some useful insights into the rationale for past financial legislation.

COMMERCIAL AND INVESTMENT BANKING IN THE UNITED STATES

As the banking system developed in the United States in the late 1800s, it generally conformed to the British theory that the two distinct functions, commercial banking and investment banking, should be conducted in separate financial institutions. Following the passage of the National Bank Act of 1864, attempts by national bank associations to engage in investment banking were rebuffed by the Supreme Court. In 1876, the Supreme Court wrote: "Dealing in stocks is not expressly prohibited; but such a prohibition is implied from the failure to grant the power." [5]

Meanwhile, state-chartered institutions and, in particular, state-chartered trust companies were formed with the authority to engage in both commercial and investment banking activities. By the turn of the century, state-chartered banks successfully pressured state legislatures for similar powers. When the Comptroller of the Currency formally ruled that national banks should *not* underwrite equities, the national banks responded by forming "securities affiliates" chartered under state law. Investment bankers began accepting deposits and expanded their activities into commercial banking. By 1914, no effective barriers existed in law or custom to prevent bank diversification into any area of customer service. The result was banking practices that no longer resembled banking theory.[6]

The advisability of these state-chartered securities affiliates was challenged as early as 1911. In that year, the Solicitor General, with concurrence by the Attorney General, in a legal opinion based upon a detailed investigation of a subsidiary of the National City Bank, questioned the legality of the emerging affiliate system. In 1912, the "Pujo Committee", which conducted an investigation of the concentration of money and credit resources, recommended legislation to prohibit national banks from underwriting corporate securities in order to prevent the domination of the securities and banking industries by a few large concerns.[7] Nevertheless, the practice continued with little public attention, since the number of investors was still small and national bank affiliates were only involved in a small percentage of the volume of new equity issues.[8]

---

[4] *Ibid.*, p. 486.

[5] *First National Bank of Charlotte* v. *National Exchange Bank of Baltimore*, 92 U.S. 122, 128 (1876). See also *Logan County National Bank* v. *Townsend*, 139 U.S. 67 (1891); and *California Bank* v. *Kennedy*, 167 U.S. 362 (1897).

Henry Cohen, "The Glass-Steagall Act: A Legal Overview", Congressional Research Service Report No. 82-189A, November 19, 1982, p. 5.

[6] Perkins, *op. cit.*, p. 490.

[7] Raymond Natter, "Formation and Powers of National Banking Associations—A Legal Primer", Congressional Research Service, Committee Print 98-4, Committee on Banking, Housing and Urban Affairs, May 1983, Chapter 4, pp. 5-6.

The sale of the government's Liberty Bonds on a massive scale to finance World War I made millions of Americans conscious of the securities markets for the first time and caused a revolution in ownership patterns of securities and the method of distribution. The opportunities for fraudulent and switching schemes—from the point of view of siphoning investors' funds out of Liberty bond purchases—also increased. The government was so concerned with the amount of fraudulent stock selling during the war that the Secretary of the Treasury and the Chairman of the Federal Reserve Board asked the Federal Trade Commission to take jurisdiction in the emergency on the theory that bad securities represented unfair competition. This government action, however, was only a wartime expedient.

Soon after World War I, the American public began investing in new security issues on an unprecedented scale. One consequence of this new supply of long-term capital was the discovery by many companies that they were less dependent on commercial banks because their borrowing needs were greatly reduced. The resulting decline in loan demand encouraged commercial banks to expand investment banking activities to offset potentially lower earnings.[9]

In 1927, Congress passed the McFadden Act which, among other things, formally affirmed the authority of national banks to engage in the underwriting of "investment securities". Following enactment of this provision, the investment activities of commercial banks grew at a rapid rate. By 1930, commercial banks had become the dominant institutions in the investment banking field; from 1927 to 1930, banks greatly expanded their share of bond underwriting from 37 percent to 61 percent.[10]

The road to securities legislation

Based upon the theory of structural separation, Congress has provided banks with a number of special privileges to support their position as the principal suppliers of impartial credit to the private sector. However, recognition of their central role in the economy and concerns about excessive concentrations of power, security of depositors' funds, conflicts of interest and unfair competition have produced a generally cautious Congressional attitude toward bank expansions into unrelated areas of business.

The history of the drive to regulate the securities industry also was characterized by tensions between competing philosophies. The philosophy of disclosure was based on the belief that investors should be provided with information on which to make an investment decision, but that they should not be prevented from making bad bargains. Another philosophy argued for greater government intervention to protect investors from bad quality issues.

As far back as 1902, the Industrial Commission, created by Congress in 1898 to consider regulation of certain private-sector industries,[11] issued a report recommending that corporations be required to publish all material facts that might be of value to investors and the public and should send their stockholders annual financial reports. The commission also urged that any prospectus which did not contain an accurate and complete disclosure of information relevant to investment decisions should be considered fraudulent and its issuers should be subject to legal action.

---

[8] *Ibid.*, p. 7.

[9] Perkins, *op. cit.*, p. 493.

[10] Perkins, *op. cit.*, p. 495.

Proposals which included some form of reporting and disclosure requirements were urged successively by Presidents Theodore Roosevelt, Taft and Wilson, as well as by Members of Congress and others. In 1912, under the auspices of the House Banking and Currency Committee, the Pujo Investigation of the "money trust" and its effect on the operation of the New York Stock Exchange found need for federal action. Still, no legislation was passed in this field.

Soon after World War I, legislation was introduced upon which the later 1930s securities legislation was patterned. These cashier bills met the same arguments that were advanced in 1933—i.e., honest investment bankers would go out of business or, in any event, require larger fees from the public. The legislation never got out of committee. It was not until the great stock market crash in October 1929 that momentum grew for passage of securities legislation.

The legislative response to the Great Crash

The impetus for reimposing compartmentalization of the financial system and for passage of securities legislation came with the Great Depression and the unprecedented failures of banks and securities firms in the early 1930s. The stock market crash of 1929 abruptly ended the post-war era of seemingly indefinite prosperity. From 1920 to 1933, some $50 billion of securities were sold in the U.S.; by 1933, half were worthless. On September 1, 1929, the aggregate value of all stocks listed on the New York Stock Exchange was $89 billion. In 1932 the aggregate figure was down to $15 billion—a loss of $74 billion in two and one-half years. Adding bond losses to this figure, the total drop in values totalled $93 billion.

---

[11] These and subsequent developments discussed in this chapter have been analyzed by Robert Charles Clark in an article entitled "The Four Stages of Capitalism: Reflections on Investment Management Treaties" *Harvard Law Review*, January, 1981, vol. 94, No. 3. Professor Clark identifies changes in the way the U.S. economy is organized and financed, and describes the legal structures devised to deal with successive stages in our economic development. He notes that Stage One—reaching back into the 19th century—was the age of the promoter-investor-manager who gave rise to the corporation as a form of business organization and the incorporation statutes. Stage Two developed as corporate power came to be entrusted to professional managers and Congress responded by designing controls (the securities laws) over the use of that power "to keep the professional working in the interest of the public security holders, so that the confidence of the latter would not be lost, and their investable funds wasted."

Stage Three is characterized by a move beyond the investment decision maker into the age of the institutional investor or financial intermediary. The critical investment decision at this stage is whether or not to relinquish funds to a particular portfolio manager or intermediary, and the "basic regulatory approach to the situation can be summed up in the concept of soundness."

The Fourth Stage, in its infancy, is the age of the "savings planner" and is characterized by a legal and regulatory focus on consumer protection. Its manifestations are apparent in the growth of pension funds and the enactment of the Employee Retirement Income Security Act (ERISA) of 1974.

Professor Clark notes that none of these stages has disappeared—all coexist contemporaneously—and that poses a challenge in terms of making regulation "respond effectively to the inherently different problems the stages present."

Following the Great Crash, the nation suffered from a contagious loss of confidence in the banking system. Between the Crash of 1929 and the "Bank Holiday" of 1933, 10,000 banks failed. In the famous "Bank Holiday" of March 1933, the entire industry ceased operations for nine days.

The collapse of the nation's financial system caused Congress to conduct a broad investigation of the stock exchange, securities markets and banking practices. This investigation led to the enactment of the Banking Act of 1933, the Securities Act of 1933, the Securities and Exchange Act of 1934 and certain amendments to the tax laws.

The congressional committees believed that many of the problems in the financial system were the result of an excessive increase in bank credit for speculative purposes—especially in the form of loans to brokers and the public for carrying securities—which had been facilitated by a substantial buildup of surplus reserves resulting from large gold imports and Federal Reserve operations. Banks had abandoned their traditional role as impartial allocators of capital and disinterested investment advisers. The Senate Banking Committee reported in 1932:

> There seems to be no difference of opinion with reference to the statement that the years after 1925, and indeed to a smaller extent those preceding that date and subsequent to 1922, were years of a very great inflation of bank credit—as well as of commercial credit and, especially in the later years, of business.
>
> Inflation was also indicated by the uses to which the credit thus established was put and the advance in prices thereby brought about. It is now evident that the increase in deposit credit on the part of the banks already described was largely used in three ways: (1) in the carrying and inflating of the prices of securities, especially common stocks, (2) in the overdevelopment of real estate and real estate enterprises, and (3) in the upbuilding of a large capital equipment paid for with short-term accommodation but not funded at the time into longer-term loans.[12]

The committees also blamed the breakdown on the growth of bank affiliates which "devote themselves in many cases to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock, often largely with the resources of parent banks." [13] Congress believed that the securities activities of banks carried out through their affiliates had fueled speculation and exaggerated business and monetary fluctuations.[14] Many be-

---

[12] Senate Report No. 584 on S. 4412, *The Operation of the National and Federal Reserve Banking System*, from the Committee on Banking and Currency, April 22, 1933, p. 3.

[13] *Ibid.*, p. 10.

[14] These views were shared by some members of the business and banking communities. Among those testifying before the Senate Banking Committee who advocated the separation of commercial and investment banking were Owen D. Young, Chairman of the Board of the General Electric Company and a member of the board of directors of the New York Federal Reserve Bank, George Davidson, President of Central Hanover Bank and Trust Company, two bankers from the Midwest, and a top manager in a Wall Street commercial bank.

In a statement by Winthrop Aldrich of the National City Bank announcing the liquidation of its securities affiliate, he conceded:

Continued

lieved that credit standards for business loans had become lax because banks had acquired the ability to liquidate a bad loan by a public offering.

The Congressional investigation found a number of questionable practices of banks' securities affiliates, including the following:

(1) lack of adequate disclosure concerning the investments offered by banks' securities affiliates, including minimal, misleading or deceptive information;

(2) bank loans to customers to finance securities purchased from banks' securities affiliates;

(3) purchases by the securities affiliates of stock in companies to which the parent banks were lenders;

(4) excessive loans by banks to their securities affiliates;

(5) use of repurchase agreements by banks to evade limitations on the amount they could loan to their affiliates;

(6) purchases of securities by banks from their securities affiliates either for the banks' own accounts or for fiduciary accounts under bank management;

(7) exploitation of the affiliates' relationship including use by securities affiliates of the name of their parent banks and bank personnel.[15]

Senator Glass commented during hearings that the general problem was that the Federal Reserve System had become inoperative:

> Instead of creating a national standard of sound banking which the states might be induced to follow, we have introduced into the national banking system some, if not many, of the abuses of the state system, in order to enable national banks to compete with state banks.[16]

A number of laws were passed in the 1930s to prevent a recurrence of these abuses and the resulting economic collapse. In 1933, Congress enacted two bills to address these problems: the National Banking Act (commonly referred to as the Glass-Steagall Act) and the Securities Act. The National Banking Act protected commercial bank depositors by:

(1) divorcing commercial banking institutions from investment banking institutions;

(2) authorizing the establishment of the Federal Deposit Insurance Corporation (FDIC);

(3) restricting the extension of bank credit for speculation;

(4) restricting branch banking and group banking; and

(5) regulating the interest paid on deposits.

The Securities Act protected investors by:

I heartily commend the action of National City Bank in taking steps to divorce its security affiliate . . . It is impossible to consider the events which took place during the past ten years without being forced to the conclusion that intimate connection between commercial banking and investment banking almost inevitably leads to abuses (*New York Times*, March 8, 1933).

[15] For a more extensive description of such practices, see Harvey L. Pitt and Julie L. Williams, "History Has Lessons for Glass-Steagall Reformers", *Legal Times*, February 15, 1982, p. 38.

[16] *The Operation of the National and Federal Reserve Banking Systems*, Hearings before a Subcommittee of the Senate Banking and Currency Committee on S. Res. 71, 71st Congress, 3rd Session, Jan. 19-23, 29-30, Feb. 2-4, 16-18, 23-25, March 2, 1931, Part I, p. 14

(1) establishing the principles of full and public disclosure to investors and potential investors of information concerning the companies whose securities they may purchase; and

(2) adopting an antifraud provision aimed at curbing speculative excesses in new issues.

In addition, the Securities and Exchange Act of 1934 conferred power upon the Federal Reserve Board to regulate the extension of bank credit on margin to securities purchasers.[17]

These acts were designed to address the speculative trends in the financial markets which led to the Great Crash. They were written to address specific abuses that Congress believed led to the Great Crash of 1929 and the Depression of the 1930s:

> The immediate measures of reform and rectification are quite important. They include the correction of evils which reached a peak of danger in 1929 and abuses which have gradually grown up within the banking system itself.[18]

Congress believed that these legislative measures would restore public confidence in the financial system and insure economic stability. Congress was not concerned about protecting either the commercial or investment banking industries from competition from the other. The laws were drafted with such particularities so as to be directed specifically at the abuses uncovered by the congressional investigations.

The Glass-Steagall Act reflected a determination that policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the "hazards" and "financial dangers" that arise when commercial banks engage in the activities proscribed by the Act. In any event, it was thought that a bank's salesman's interest might impair its ability to function as an impartial source of credit.[19]

The Bank Holding Company Act

Following the 1930s reform legislation, U.S. financial structure remained relatively unchanged for several decades. Congress made some important regulatory decisions in the interval: it approved the Investment Company Act in 1940 which provided for the regulation of mutual funds and the McCarran-Ferguson Act in 1945 which formally ceded to the states authority to supervise and regulate insurance companies and continued the exemption of the insurance industry from anti-trust laws (which dates back to the 19th century).[20] But these and less important additions to laws governing financial institutions and markets left untouched the basic provisions and objectives of the 1930s Acts.

The Bank Holding Company Act of 1956, however, reflects an effort to grapple once again with structural decisions. It was the first of a series of efforts to prevent evasions of restrictions in the banking laws by bringing new, unregulated entities under the regulatory umbrella. The 1956 Act provided for the regulation of bank holding companies, set limits on their expansion and their acquisitions of banks across state lines and reaffirmed the Glass-Steagall separation of banking and commerce. Once again, these issues appeared to have been settled. But the 1956 Act covered only multibank holding companies, and subsequent amendments in 1966 continued the exclusion of one-bank holding companies on the grounds that "there was no substantial evidence of abuses" related to this form of operation.[21]

---

[17] Arnold Sametz, *Securities Activities of Commercial Banks*, Chapter 2, "Background of the Controversy Over Banks' Securities Activities—A Briefing", Lexington Books, Lexington, MA, 1981, p. 10.

[18] 1933 Senate Report, *op. cit.*, p. 2.

[19] *Investment Company Institute v. Camp*, 401 U.S. 631 (1971).

[20] Further discussion of the insurance industry regulation can be found in Part III, Chapter 1.

When the 1966 amendments were passed, there were about 600 one-bank holding companies which were primarily small institutions with aggregate deposits of $15 billion or about four percent of total bank deposits.[22] But the failure to include these institutions in the Act's restrictions (despite the Federal Reserve Board's urging) led to a virtual revolution in banking practices and financial structure over the next three years. The background for these developments is described in a 1974 article published by the Federal Reserve Bank of Boston:

> . . . Banking product and geographic extension had been given an impetus throughout the 1960s by liberal rulings of Comptrollers of the Currency Saxon and Camp, as to what constitutes "incidental powers necessary to carry on the business of banking" under the National Bank Act. However, bankers who sought to engage in such activities directly often faced lawsuits from nonbank competitors and state banks operating under more restrictions. The bank-formed OBHC (One-Bank Holding Company) seemed to offer less risk of such legal action and complete freedom from regulation. Moreover, it had, and has, advantages as a convenient device to overcome restrictions on funds and offers potential organizational benefits.[23]

Shortly after Congress' decision not to regulate one-bank holding companies, a number of banks followed the lead of the First National City Bank (now Citibank) and formed holding companies while other banks were acquired by non-banking companies. Between 1966 and 1969, another 210 OBHC's were formed, bringing the total number to 810. But total deposits of OBHC's rose to $135 billion or about 35 percent of total bank deposits. By comparison, the 100 regulated multibank holding companies held only about 15 percent of total bank deposits.[24]

At the beginning of 1969, there was a rapid escalation in these developments. In the first 10 weeks of the year, 31 banks with more than $24 billion of deposits formed or announced plans to form OBHC's.[25] But it was not the numbers of banks alone that finally galvanized Congress and the new administration to take action. As Undersecretary of the Treasury Charls E. Walker explained to the Senate Banking Committee in 1970, the Nixon Administration had come to the conclusion in its first weeks in office that it had to recommend legislation to regulate the formation of one-bank holding companies, ". . . not because it represented a real threat to the safety and solvency of the banks . . ." but because:

---

[21] Senate Report No. 1179, 89th Congress, 2d Session (1966), p. 5. This and subsequent quotations and much of the factual information in this section are drawn from Roy A. Schotland, "Bank Holding Companies and Public Policy Today", *Financial Institutions and the Nation's Economy*, Compendium of Papers Prepared for the FINE Study, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Congress, Second Session, June 1976, Book I, pp. 236-239.

[22] *The Growth of Unregistered Bank Holding Companies—Problems and Prospects*, Committee on Banking and Currency, U.S. House of Representatives, 91st Cong., 1st Sess., 1969, p. 1.

[23] Boxman, "Bank Holding Company Trends in New England", *New England Economic Review*, Federal Reserve Bank of Boston, 1974, p. 5, note 5.

[24] *The Growth of Unregistered Bank Holding Companies—Problems and Prospects*, op. cit., p. 1.

> . . . we were concerned about a movement that we felt could and probably would ultimately change the very face of American capitalism. This is known in Japan as the Zaibatsu arrangement. We feared that if this trend continued, as it was moving in 1968, with more and more conglomerates acquiring banks and probably some bank holding companies moving into the conglomerate area, that over a period of perhaps a decade or less we would end up with 40, 50, 60 major centers of economic and financial power in each of which a conglomerate would dominate a large bank or a multi-billion dollar bank would dominate a conglomerate.[26]

Certainly there was visible evidence to support this concern. Montgomery Ward, Baldwin Piano and S. & H. Greenstamps had formed one-bank holding companies, and Leasco Data Processing Equipment Corporation—an emerging conglomerate—had attempted to acquire Chemical Bank New York Trust Company. Meanwhile, the newly-formed First National City Corporation (now Citicorp) had acquired a major mortgage banking firm and a major management consulting firm. The House Banking Committee study noted that, between 1966 and year-end 1969, 27 conglomerates had acquired or established banks; and one-bank holding companies were then engaged in 20 different financial activities and 99 different non-financial activities.[27]

The Bank Holding Company Act Amendments of 1970 represented a compromise between those who wanted to eradicate the one-bank holding company structure altogether and limit banks to traditional activities and those who believed some expansion of banking activities was justified (or just inevitable) and that the holding company structure offered an acceptable degree of protection from risk. Both sides, however, agreed on the central issue. The consensus view was expressed by President Nixon who stated that the overriding purpose of the Act was to preserve the long-standing separation between "the suppliers of money—the banks--and the users of money—commerce and industry."[28]

---

[25] *Ibid.*, p. 1

[26] Testimony of Charls E. Walker, *Hearing on One Bank Holding Company Legislation*, Committee on Banking and Currency, U.S. Senate, 91st Congress, 2nd Session, 1970, p. 13

[27] *The Growth of Unregistered Bank Holding Companies—Problems and Prospects*, op. cit., p. 1.

[28] Message of the President, March 24, 1969, quoted in Conference Report 91-1747, Statement of the Managers on the Part of the House, 91st Congress, 2nd Session, 1970

But, aside from what was thought to be an unequivocable repudiation of the Zaibatsu arrangement and (once again) a reaffirmation of Glass-Steagall, other elements of the 1970 Act reflect a significant degree of compromise. While the Douglas Amendment to the 1956 Act was also reaffirmed and applied to the one-bank holding company as it had been to multibank holding companies, interstate restrictions were not applied to the non-banking subsidiaries and affiliates of the holding company. Moreover, neither side won a clear-cut victory with respect to the issue of expanding banks' powers. Confining bank holding companies' subsidiaries and affiliates to activities "closely related to banking" was too great a degree of liberalization for some, too little for others.

Even the degree of regulation of what had been wholly unregulated entities was a subject of controversy during and after passage of the Act. There was widespread agreement that the organization and expansion of one-bank holding companies should be regulated, but less agreement on the degree to which non-banking entities within the holding company should be regulated. Some argued that they should enjoy as much freedom from supervision and regulation as companies owned by non-bank competitors. Others thought that regulatory safeguards for non-banking activities affiliated with banks should be stronger than for companies not associated with banks.

In view of these differences, Congress gave the Federal Reserve Board considerable discretion in formulating regulations and in determining what kinds of activities are "closely related to banking". But the differences in view—now expressed in criticisms of the Fed—persist. Some believe the Fed has been lacking in discretion; some that it is too discreet.

In any event, there is no doubt that the Bank Holding Company Act Amendments of 1970 radically changed the environment in which banks function. Permitting banks to engage in non-traditional activities has, in fact, increased risk despite efforts to insulate banks through the holding company structure and restrict loans to affiliates.[29] And while the 1970 Amendments upheld Glass-Steagall provisions separating banking and securities activities until, in 1983, the Federal Reserve ruled that discount brokerage is "closely related" to banking, it is clear in retrospect that they have had the effect of eroding the separation between banking and other financial services. Banks have moved into direct competition with nonbank financial intermediaries and nonfinancial companies offering similar services. The result has been a proliferation of competitive inequities and renewed and enhanced pressure for structural change.

---

[29] The evidence and rationale for this assertion is discussed elsewhere in this report (see, for example, Part II, chapters 2 and 3). Nevertheless, many would agree with the view offered by Stephen J. Friedman in a June 5, 1985, letter to the Subcommittee:

> If you put aside international operations in which most of the sacred tenets of American banking are laid aside, I am not sure that [the holding company structure] is the source of increased risk. Most of what holding company subsidiaries do are authorized activities for banks themselves—leasing, mortgage banking, finance companies, loan production offices, etc. In fact, I think that a quite convincing case can be made for the notion that the increased risk in the banking system has come from traditional banking activities—managing volatile interest rate risk, liquidity problems, bad loans, and bond and currency trading.

No one would deny Mr. Friedman's assertion that traditional banking activities have become more risky in recent years (See Part II, Chapter 2 and Part III, Chapter 7). Nevertheless, as discussed above, differences in regulation of activities undertaken within the bank and through subsidiaries and the practice of funding nonbanking affiliates in the commercial paper market made the holding company structure a more risky way of conducting even authorized banking activities.

THE EMERGING TREND TOWARD FINANCIAL CONSOLIDATION

Although attempts to exploit loopholes in Glass-Steagall were pursued aggressively in the 1960s, the Bank Holding Company Act Amendments of 1970 reaffirmed the appropriateness of distinctions between financial functions and the separation of banking and commerce by requiring that non-traditional banking functions be undertaken by subsidiaries of the banks' holding companies and that they be "closely related to banking". Banks were permitted to offer services through subsidiaries—credit card operations, leasing, factoring, for example—that when offered by non-banks had not been regulated at the Federal level. Their principal competitors in these new activities were finance companies which are regulated by states and by the Federal Trade Commission when their operations are conducted across state lines. The new bank subsidiaries were also permitted to operate across state lines even though banks themselves were not.

Similar developments were taking place at this time in the insurance industry, the only major financial sector that is not regulated at the national level.[30] Until after World War II, the life and property-casualty sectors of the industry had been separate and even property-casualty insurers had tended to be segregated into specialties such as fire or theft insurance. In the 1960s, a wave of acquisitions of insurance companies by nonfinancial firms resulted in dramatic changes in the industry. It also prompted the National Association of Insurance Commissioners to draft a model insurance holding company act that was eventually adopted by 46 states and the District of Columbia.

Some of those who participated in framing the 1960s legislation governing the insurance industry saw it as an anti-takeover act. Under the acquisition-of-control provisions, the Model Act lays out strict substantive tests that must be met by an acquiring company that are similar to those in the Bank Holding Company Act.[31] But the Model Act did not prohibit acquisitions of insurance companies by nonfinancial companies. It in effect ratified this new development. And, except for life insurers, the holding company provisions do not limit the business activities in which insurance companies may engage through subsidiaries.[32] As a result, it is now difficult to unravel how much of the activities of a given conglomerate are insurance.

Even the more restrictive provisions in the Model Act governing life insurers—provisions remarkably similar to the "closely related" test in the Bank Holding Company Act—allow these intermediaries to act as broker-dealers for their own account (but not for the public), to manage investment companies (mutual funds) and set up commingled accounts for variable annuity and variable life insurance programs. Comparable powers were denied banks under the 1970 Act and the competitive position of insurance companies as managers of investment funds was enhanced. By 1974, they managed about half of all pension funds—an activity in which they were in direct competition with bank trust departments.[33]

---

[30] Insurance companies are regulated by the individual states with coordination provided by the National Association of Insurance Commissioners (NAIC) to provide some degree of similarity in statutory and regulatory treatment. Regulation of the insurance industry is discussed in Part III, Chapter I.

[31] These tests reflect concerns for soundness and policy holder protection as well as antitrust concerns.

[32] Robert Charles Clark, "The Regulation of Financial Holding Companies," *Harvard Law Review*, vol. 92, February 1979, pp. 803-808.

Meanwhile, the stock market boom of the 1960s introduced new pressures for structural change in the securities industry. More capital was needed to meet minimum regulatory standards as operations (and earnings) of securities firms expanded. But securities firms were subject to New York Stock Exchange (NYSE) rules that required that members be structured as partnerships.[34] Perhaps because partners (who are both owners and managers) are less likely to forego earnings to augment capital than are shareholders in publicly-held companies,[35] slow growth in the capitalization of the industry resulted in significant constraints on capacity. Thus, following discussions initiated by Merrill Lynch in the late 1960s, the NYSE relaxed its rules, permitting its member firms to go public to raise new capital.

This change had major structural implications that were not widely recognized at the time. Partnerships, like mutual companies (a common form of organization among life insurers and thrifts) do not raise capital by floating new stock or bond issues. Their reliance on retained earnings for the capital necessary to acquire other companies means that adding subsidiaries and affiliates engaged in other lines of business is more difficult than in the case of publicly-owned companies. However, as securities firms shifted to public ownership, opportunities for diversification increased.[36]

To some extent, the competitive disparities set in motion in 1969 and 1970 by adoption of the model insurance company act and the Bank Holding Company Act Amendments set the stage for more recent changes in financial structure. But finance companies, which have been and remain at the fringes of the financial services industry, also played a role as catalysts in the trend toward consolidating financial services.

Sears Financial Services has been considered the model for the consolidated financial services firm. It is also the primary example of a commercial firm that has undertaken a major expansion into financial services. But, until recently, its financial activities were well within the boundaries of the financial functions of other commercial enterprises. While Sears has owned a locally oriented thrift for decades, its principal financial service (other than customer credit for its retail operations) was insurance and, as noted, the acquisition or formation of property-casualty insurance by other commercial companies had become commonplace in the 1960s and was explicitly sanctioned by the model insurance holding company act.[37]

---

[33] *Ibid.*, pp. 808-810.

[34] It was believed that this form of organization—without the limited liability enjoyed by publicly-owned companies—would augment the effectiveness of major elements of securities regulation; that it would enhance underwriters' responsibility to scrutinize information disclosed by issuers and discourage fraud.

[35] Owners and managers of publicly held companies are not necessarily the same people and their interests may differ with respect to the issue of retained earnings. But shareholders can more readily realize any gains in the value of ownership that results from retaining earnings to augment capital by selling some (or all) of their stock.

[36] This is also true for many life insurers and thrifts that have more recently begun to shift from mutual to stock companies.

Aside from the fact that Sears was not the only commercial enterprise engaged in insurance activities, its customer credit activities were a more commonplace example of the commingling of finance and commerce that emerged in the Post-World War II period. Other retailers and the major automobile manufacturers—General Motors, Ford and Chrysler—also made loans to customers. The commingling of consumer finance and commerce became the rule, rather than the exception, until the 1970s when banks acquired a larger share of the market through their finance company subsidiaries and credit card operations.

As the links between finance companies and banks proliferated, those between finance companies, commercial enterprises and other financial intermediaries also expanded. Thus, financial intermediaries found themselves competing head-on with both financial and nonfinancial entities outside their traditional lines of business. As a result, pressures built for a further expansion of the range of activities for individual financial sectors.

That there has been a major shift toward the consolidation of functions within what we now call "the financial services industry" has become increasingly obvious. For the most part, these developments have occurred without legislative sanction.[38] And in the absence of legislative direction for structural change, it is generally assumed that market forces—in particular, changes in the macroeconomic environment, in technology and in customers' demands for financial services—are responsible for the scope and rapidity of change. In cases involving depository institutions, however, the changes that have occurred would not have been possible had Federal and State regulators been unwilling to sanction the exploitation of loopholes.

Mergers between property-casualty insurers and securities broker-dealers or underwriters, on the other hand, have not been characterized by the exploitation of loopholes or relaxation of regulatory restrictions because these restrictions have never existed.[39]

---

[37] The further expansion of commercial enterprises into insurance activities through offshore, "captive" subsidiaries is discussed in Part III, Chapter 3.

[38] The exceptions are the Depository Institutions Deregulation and Monetary Control Act of 1980 which authorized depository institutions other than commercial banks (thrifts and credit unions) to offer transactions accounts, and the Garn-St Germain Act of 1982 which gave savings institutions limited powers to deal with commercial customers—powers that had previously been reserved for banks. These Acts also provided for a phasing out of regulatory restrictions on interest paid on deposits—changes that were seen as necessary to maintain the viability of depository institutions (especially thrifts) and enhance their ability to compete with non-depository institutions such as money market mutual funds. Thus, it could easily be argued that interest rate deregulation was an effort by Congress to preserve the existing financial structure by strengthening and perpetuating the advantages of depository institutions in offering deposit services. But, at the same time, it is clear that interest rate deregulation has helped erase distinctions between depository and other financial services.

[39] Insurance companies, however, had not tended to engage in other activities until the 1960s. As discussed, the model insurance holding company act adopted by the States was a response that both sanctioned and provided guidelines for affiliations between insurers and financial and nonfinancial companies.

Life insurers, however, had been restricted to the business of life insurance in many states and the liberalization of restrictions on their activities as a result of adoption of the model act resulted in a rapid expansion of their role as investment managers of mutual and pension funds in the 1970s and in the formation of affiliates to deal in securities for their own account (but not for the public). Nevertheless, mergers between insurance companies and securities firms only began to occur contemporaneously with their entry into depository activities. While a further relaxation of restrictions on life insurers (in 1983) by New York—the home state for many of the largest companies—augmented this development, the movement toward the financial supermarket was encouraged by a shift in the regulatory environment for depository institutions.

The most recent shift in regulatory views occurred at the end of the 1970s but, as noted above, bank regulators had participated in the attempt to exploit loopholes in Glass-Steagall in the 1960s as well. Moreover, as the FINE Study pointed out, a very different regulatory environment for banks' overseas operations has existed throughout the post-war period and a number of foreign subsidiaries and affiliates were approved in the 1960s and after passage of the Bank Holding Company Act Amendments of 1970 that did not conform to the "closely related to banking" definitions of that Act. Of particular importance is the fact that U.S. banks have been permitted to engage in a wide range of securities activities—including underwriting corporate bonds—and insurance activities outside the United States, and that U.S. securities firms and insurance companies have been allowed to engage in banking activities offshore. The major U.S. multinational banks, securities firms and insurance companies have been in continuous competition as providers of financial services for U.S. and foreign multinational corporations for more than a decade.

Federal bank regulators' commitment to maintaing a separation between banking and securities activities in the domestic market was nevertheless reaffirmed in their support for the International Banking Act which prohibited foreign banks from engaging in securities activities in the United States and required that they conform to the Bank Holding Company Act with respect to nonbanking activities.[40] The major U.S. multinational banks opposed restrictions on foreign banks on the grounds that such restrictions might jeopardize their ability to provide services that foreign banks were permitted to provide in their home markets and thus undermine their competitive position abroad. The Federal Reserve Board resolved this potential threat by promoting the concept of "national treatment" for international banking operations in the major industrial countries—that is, that foreign banks would be required to meet the same regulatory requirements as domestic banks and be given the same competitive opportunities. With passage of the IBA in 1978, another major threat to Glass-Steagall separations of banking and securities activities in the domestic market was thwarted.

---

[40] This legislation was first introduced in 1973, debated by the Congress in 1975 and 1976 and passed by The House in 1976. Consideration was resumed in 1977 and the bill was enacted in 1978.

These various developments—the model insurance holding company act, the Bank Holding Company Act Amendments of 1970, securities firms' shift from partnerships to publicly-owned companies, the movement of commercial firms into consumer finance, and U.S. financial institutions' growing involvement in a wider range of activities overseas—set the stage for the more rapid consolidation of financial activities that occurred in the 1980s. This new stage has been characterized by the movement of both commercial companies (such as Sears) and financial companies (such as Merrill Lynch) into real estate activities that have not traditionally been regarded as financial in nature, and by the growing involvement of bank holding companies, nonbank financial companies and commercial companies in mortgage banking activities which have traditionally been conducted by non-depository institutions outside the federal regulatory framework.

It was, however, Sears' recent movement into securities activities (its acquisition of Dean Witter in 1982) that consolidated its position as the first full-service financial "supermarket", owning companies that offer different financial services and making them available to the individual customer in a single location. And Sears' subsequent efforts to move into "consumer banking" are illustrative of a fundamental fact about financial structure: that authority to accept insured deposits and tie credit to a deposit relationship confers unique market power. However embryonic Sears' involvement in deposit-taking may be presently, its proposal to expand its banking operations suggests that an expansion of funding sources is essential to the financial supermarket. Opportunities to expand services are limited if a given financial institution must rely on other financial intermediaries for funding. Opportunities for expansion increase in proportion to the ability of an institution to match sources and uses of funds within the consolidated enterprise.

Thus the issue of bank powers is, and will remain, a critical issue in determining U.S. financial structure. And because an expansion of bank powers results in a symmetrical expansion of the classes of institutions engaged in other activities that can own banks, the various proposals for financial restructuring that are described in this report [41] cannot be evaluated solely on the basis of how well they address the issue of competitive equity for financial institutions and sectors. The real issue is far more radical in nature than that framework for argumentation suggests. It involves decisions to encourage or discourage the trend toward financial consolidation—a trend that will result in a financial system that is very different from the one that has been in place throughout most of U.S. history, and one that has profound implications for existing safeguards that ensure the soundness of financial institutions and protect their customers.

---

[41] These proposals are outlined in Part I, Chapter 4 and their implications are analyzed in Parts II and III

CURRENT U.S. DEVELOPMENTS

While the restructuring of financial services in the United States that has occurred since the end of the 1970s has been remarkable and dramatic, it would be misleading to suggest that these developments are unique. As the above historical discussion reveals, many of these structural changes and the way they are occurring have their antecedents in developments in the late 1920s and 1960s. Moreover, the transition process that has now quickened dramatically actually began much earlier in the decade with gradual changes in the domestic market in response to changes in the macroeconomic environment and other developments, and had as its counterpart and precursor the restructuring of the domestic insurance industry and of financial services offered by U.S. institutions in offshore markets in the 1970s.

Similarities between trends in restructuring now and those in the 1920s are evoked by the significant degree of integration of banking and securities activities and the degree to which that integration has resulted from differences in regulation. Examples of the proliferation of bank involvement in securities activities include the pooling of trust accounts, dividend reinvestment accounts and discount brokerage. The first two are the result of a more gradual evolution in the regulatory environment. The movement into discount brokerage is the result of the more recent follow-the-leader regulatory responses.[42]

In 1982, the Federal Home Loan Bank Board gave thrifts permission to engage in brokerage through INVEST; the FDIC ruled that insured state non-member banks were legally exempt from restrictions against banks' underwriting of corporate securities, and the Comptroller of the Currency authorized a joint venture between a major bank and a discount broker.[43] With 200 to 300 banks engaged in such joint ventures[44] the Fed was forced to concede that discount brokerage is "closely related to banking," motivated perhaps by the hope of encouraging banks to conduct their brokerage activities through affiliates rather than within the bank itself.[45]

In addition, securities firms and other financial institutions moved into banking by acquiring or establishing nonbank banks. The nonbank bank is a recent institutional innovation created to exploit loopholes in the banking laws.[46] By electing to undertake only one of the two activities (accepting demand deposits and making commercial loans) that are used to define the business of banking in the Bank Holding Company Act, the nonbank bank can evade restrictions in that Act and in Glass-Steagall as well.[47]

---

[42] See Part II, Chapter 4 and Part III, Chapter 1 for further discussion of discount brokerage.

[43] The first such approval involved a joint venture between Security Pacific National Bank of Los Angeles and Fidelity Brokerage Services of Boston.

[44] Estimates provided by the American Bankers Association in "Discount Brokerages Allowed Banks by Fed," *New York Times*, August 11, 1983, p. D 1.

[45] The Fed took more than a year to approve the acquisition (in January 1983) of Charles Schwab, the largest discount broker, by Bank America Corporation, holding company for the largest U.S. bank. Along with its August 10, 1983 ruling adding brokerage services to the list of activities that bank holding companies may engage in, it authorized Chase Manhattan Corporation to acquire Rose and Company Investment Brokers Inc. of Chicago.

[46] See Part II, Chapter 1 and Part III, Chapter 1 for further discussion of nonbank banks.

[47] As of May, 1985, further exploitation of this loophole had been halted by the 11th Circuit of the U.S. Court of Appeals decision (*Florida Department of Banking v. Board of Governors of the*

Continued

Securities firms that are now operating insured nonbank banks under national or state charters include: Dreyfus Corporation, Shearson Lehman/American Express, Merrill Lynch, E. F. Hutton, Marsh and McLennon, First Boston, Paine Webber, and Drexel Burnham Lambert, and a major insurance and securities conglomerate, Prudential-Bache. In addition, several major securities firms positioned themselves to enter banking activities by buying up to five percent of the stock of existing banks.

There are similarities between current developments and those in the 1960s as well. The "Zaibatsu Problem" has been revisited (in all but name) with the movement of a number of commercial enterprises into banking, exploiting both the nonbank bank loophole and the absence of restrictions on the ownership of savings and loan holding companies that own only one depository institution. While not wholly unregulated as was the one-bank holding company,[48] the nonbank bank and the unitary savings and loan holding company are no less effective devices for circumventing those particular restrictions that separate, to repeat President Nixon's phrase, "the suppliers of money—the banks—and the users of money—commerce and industry."[49]

Meanwhile, banks themselves exploited the nonbank bank loophole to circumvent restrictions on interstate banking. Some viewed this development as one that could dramatically increase concentration in the banking industry given the reliance in current law on geographic restrictions as a primary constraint on expansion. But concentration—and conflicts of interest—are concerns that arise in the case of developments involving other financial sectors as well. The recent trend toward combinations of insurance and investment banking activities—for example, Allstate and Dean Witter under the Sears umbrella, American Express and Fireman's Insurance, Prudential-Bache and the merger of Equitable and Donaldson, Lufkin, Jenrette—could result in the domination of major financial functions such as corporate finance and money management by a few, very large financial conglomerates. These developments raise particular concerns because there are now no restrictions on links between these financial sectors and commerce and, in the case of the insurance industry, such links are already well established.

As discussed, similar developments involving the combination of financial functions have occurred in the past. What is perhaps unique in the current situation is the extent of the duplication of

---

Federal Reserve System, 760 F.2d 1135) on nonbank banks. On January 22, 1986, the Supreme Court ruled in another nonbank bank case (*Board of Governors of the Federal Reserve System vs. Dimension Financial Corp.*) that the Federal Reserve had exceeded its authority in its efforts to bring these new types of banks within its jurisdiction. The Supreme Court then issued an opinion remanding the Florida case back to the Court of Appeals, ordering them to reconsider it in light of the Supreme Court decision in the Dimension case.

[48] Because most nonbank banks are formed or acquired for the purpose of attracting insured deposits, they fall under FDIC supervision and regulation. Federally chartered S&L's are regulated by the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation and state chartered S&L's by state authorities.

[49] Among the larger commercial enterprises that now control or are affiliated with nonbank banks or savings and loan institutions are Gulf and Western, Sears Roebuck and Co., Landmark Land Company, J. C. Penney, General Electric, and Kroger Company. Commercial firms are also increasingly involved in securities and insurance activities as well, as exemplified by Sears' activities in both fields, the merger of Phibro and Salomon Brothers and Baldwin Piano's foray into insurance.

products by different financial sectors. Securities firms now offer traditional bank products which not only include the much-discussed alternatives to transactions accounts (money market mutual funds) but direct payroll deposit and bill-paying services as well.[50] Insurance companies have invaded the short-term corporate lending market traditionally reserved for banks, funding their loans in the commercial paper and Eurodollar markets. Both banks and securities firms now offer discount brokerage services and deal in commercial paper. Banks offer other products such as pooled trust accounts that are similar to shares in investment companies and compete with insurance companies in managing pension funds. Commodities and securities firms are also in direct competition for similar products, the former offering stock index futures and the latter stock index options.[51]

The current situation is also characterized by a resurgence in competitive regulatory initiatives involving depository institutions by states after fifty years of more or less quiescent acceptance of the dominant Federal role. Massachusetts, Connecticut and New York have authorized mutual savings banks to engage indirectly in insurance activities. South Dakota enacted legislation permitting state chartered banks to engage in a full range of insurance activities and similar legislative initiatives are being considered by Delaware, Maine and Minnesota. South Dakota's law would also permit out-of-state banks to establish state chartered institutions for the purpose of underwriting and selling insurance provided their business is conducted with out-of-state residents.[52] In other states, banks are entering into cooperative agreements with insurance companies to let insurance agents market their products on bank premises.

Many states have also liberalized investment powers of financial institutions. The California and Ohio state legislatures have enacted legislation that authorizes commercial banks and thrifts to engage directly in real estate investments and to invest in corporate securities. New York has also granted real estate investment powers to state-chartered savings banks and thrifts in addition to authorizing corporate debt and equity investments for thrifts, and has liberalized the investment powers of life insurers. In addition, two thrift institutions are operating securities affiliates under "leeway investment" provisions in state law that permit banks to invest a certain percentage of their capital in any nonbanking activity.[53] Expanded state banking powers are discussed in more detail later in the report.[54]

---

[50] Merrill Lynch, the Fidelity Group, Dean Witter, the Calvert Group and the Vanguard Group are among the securities firms now offering insured cash management accounts with checking privileges at market rates of interest. Fidelity Group's Asset Management Account offers additional complementary services including direct payroll deposit and telephone bill-paying services.

[51] Issues related to overlapping products are discussed in Part II, Chapters 1 and 4, and Part III, Chapter 1.

[52] So far this law has not been utilized. The Federal Reserve Board held up pending applications by Citicorp and Bank of America, and in August, 1985, denied Citicorp's application.

While this summary is by no means all-inclusive and is certain to be out-dated within a very short time, it does provide some indication of the scope and complexity of current developments. It also supports by way of illustration the frequently discussed assumptions that traditional boundaries between financial products and services and between finance and commerce have been significantly eroded. Unless these developments are reversed by congressional initiatives, the current regulatory framework, based on the separation of products and services, will be inapplicable to the emerging new financial marketplace.

AN ALTERNATIVE MODEL: THE GERMAN UNIVERSAL BANKING SYSTEM

Introduction

Although there has been a long-standing consensus in the United States favoring the British model of financial structure, there also have been repeated attempts to promote a model characterized by universal services. For the most part, they have been reversed. Now, however, the blurring of distinctions between financial institutions, sectors and products has become so pervasive and widespread that the potential for reinstating a rigidly segregated system is less likely than in the past.

If, as many have suggested, deregulation of financial institutions in the United States will result in a financial system characterized by universal services firms similar to those found in some foreign countries, it may be useful to examine the financial structure found in those countries. The German universal banking system is the model that most closely resembles the more consolidated financial system that is being proposed by current deregulatory strategies in the United States.[55] Other countries have very different ways of organizing the structural and regulatory framework for their financial systems with very different consequences in terms of the interaction of the financial system and the economy. The Japanese financial system, for example, is diverse and disaggregated like that of the United States, but subject to tighter government control. In Germany, as in the United States, the influence of the public sector is less pervasive.

Nevertheless, as the following brief discussion of the German financial system suggests, the German experience raises questions about the appropriateness of this model for the United States.

---

[53] They are Washington Mutual Savings Bank, Seattle which is currently operating a full service brokerage subsidiary and Boston Five Cent Savings Bank of Boston, Massachusetts which has organized two wholly owned subsidiaries to advise and distribute shares in a mutual fund (Memorandum to the Board of Directors and Budget Management Committee of the Federal Deposit Insurance Corporation from the Staff of the Division of Research and Strategic Planning *re* the Need to Rulemake with Regard to Indirect Involvement by Insured Banks in: Real Estate, Insurance, Data Processing, Travel Agency Activities, and other Financially Related Activities, August 12, 1983, p. 4).

[54] See Part III, Chapter 1.

[55] Except that, in Germany, commercial and industrial firms do not own banks.

Characteristics of the German financial system

In Germany, a separation between investment and commercial banking has never existed. The universal banks act as brokerage houses, commercial banks, investment banks and industrial shareholders—all at the same time. Thus, they engage in practically all types of business typical to commercial and investment banks. They receive deposits, lend funds, underwrite stock transactions, buy and sell securities and bonds, hold and vote by proxy the securities of depositors, and manage portfolios.

This system has resulted in the development of close ties between banks and private businesses and a greater degree of capital and corporate concentration than exists in the United States. The German banks have a great deal of influence on corporate decision-making because they play the roles of capital providers, stockholders and board members for businesses.[56] The interlocking relationship between the financial and industrial sectors in West Germany is the strongest among the major industrial economies.

Since the onset of industrialization, economic circumstances in Germany encouraged close economic relations between banks and industry. In the course of the industrial revolution, the financial needs of the emerging industrial enterprises were met through massive extensions of bank credit because the equity and bond markets in Germany were not capable of meeting those needs. After World War II, the German capital market was again very weak and the banks' role as providers of long-term funds was reinforced. The universal banks played an indispensable role in the establishment of a stock market after 1945 and they continue to play an important role in expanding the capital market. However, only representatives of credit institutions are allowed to operate on the stock exchange. Since there is no ban on banks' acquisitions of shares and participations in industrial enterprises, they operate both on behalf of their clientele and for their own account.[57]

Despite efforts to expand the equity market, the capital structure of German enterprises generally continues to be thin, creating a degree of risk for corporations. Equity capital makes up, on average, only 20 percent of companies' capital structure, down from 30 percent a decade ago. In the Federal Republic in the period 1970–1979, approximately 80 percent of external corporate financing was in the form of fixed-interest loans for 10 years or more, in contrast to the United States where bond issues play a major role in corporate finance.[58] This heavy reliance on bank loans for external corporate financing necessarily limits the size and trading activity of German securities markets. Only 405 companies are quoted on the Frankfurt bourse. The most active 20 stocks make up over half the volume and the uncrowded exchange floor is open only two hours a day.[59]

---

[56] Arlene Wilson, "Major Structural Differences Among the Economies of the United States, Germany and Japan: An Overview", Congressional Research Service, Library of Congress, October 1979, p. 41.

[57] Salvatore Mastropasqua, *The Banking System in the Countries of the EEC: Institutional and Structural Aspects*, Sijthoff and Noordhoff International Publishers, 1978, p. 112.

[58] Arlene Wilson, Congressional Research Service, *op. cit.*, p. 42.

[59] "Watch on the Rhine", *Forbes*, November 7, 1983, p. 122.

The trend in capital financing in Germany probably is due to a combination of factors in addition to the policies of the universal banks. Other factors include the tax structure which, before 1977, discouraged equity financing, and a strong preference by capital suppliers in the Federal Republic for liquidity. Universal banks, therefore, have developed the role of transforming short-term savings into medium- and long-term capital. But that role is self-perpetuating since it tends to constrain the liquidity of secondary markets in securities.

Advantages and disadvantages of the universal system

Some contend that the role of the German banks made possible the nation's rapid industrial reconstruction and development after World War II. However, the assertion that the full-service banking system contributed to the nation's high rate of growth has been debated hotly in Germany. Certain aspects of the universal system have been controversial for quite some time. Many critics believe that any benefits resulting from the universal banking system may be outweighed by disadvantages—primarily, excessive concentration and conflicts of interests. Although it is unlikely that the universal system will be dismantled, a number of recommendations have been made in recent years to address problems of excessive participation by banks in private business.[60]

German proponents of the universal structure argue that the large financial institutions are remarkably responsive to corporate needs and provide greater convenience by allowing customers to conduct all financial business "under one roof." They argue further that the universal system is more efficient because the information needed by financial institutions and the decision-making skills of personnel in connection with the offering of various financial services are similar. Utilization of customer information gathered in connection with existing business relations decreases the cost of procuring information when additional services are incorporated into the portfolio.

Critics, however, contend that banks have excessive control over corporate financing. It is alleged that, in counselling customers, the universal banks tend to favor the lending and savings side of their business—even when a corporation's capital requirements could be met more appropriately with equity capital—because they are heavily dependent on deposits to supply their financing needs. In addition, they argue that the German banks approach the equity market with a "loan mentality", fearing that more aggressive forays into the stock market might put their depositors' interests at risk. Meanwhile, corporations, fearful of jeopardizing their special relationship with their major creditor, do not feel free to shop around for alternative or cheaper methods of raising funds.[61]

Other critics believe that the underdeveloped equity market in Germany is the result of the conflict of interest that arises when a bank is involved in both commercial lending and equity underwriting. Every mark raised in equity capital is a mark that a corporation doesn't need to borrow from the bank.[62] The overall result of these banking practices, critics argue, is a weak stock market and undercapitalization of the German economy.

---

[60] A recent example is the Gessler Commission, the government's investigatory committee on banking practice, which made a number of recommendations in 1979. The Commission, created to study West Germany's banking operations, generally favored the universal system, but recommended limitations on shareholdings of industrial corporations by banks.

[61] John Tagliabue, "German Banks in Uneasy Mood", *New York Times*, November 28, 1983, p. D9.

It has been alleged that because of the banks' special role as investment counsellors and their access to information, banks on occasion withhold information from general securities customers in order, for example, to protect both credit customers and themselves from the adverse effects that might result from knowledge of unfavorable economic or financial developments. This type of behavior ultimately could lead to customer mistrust and a decline in confidence in (and impairment of) the functioning of the securities market.

Proponents of the universal services system argue that diversification of balance sheets by universal service institutions in the Federal Republic stabilizes financial institutions, the financial system and the economy. To better cope with market fluctuations, universal firms can stabilize their earnings by offering services that do not have parallel profit curves. Losses in one sector of operations are neutralized by positive developments in another.

It also has been argued that universal banks stabilize the equity markets. Since banks are dependent upon a stable, healthy securities market to absorb their long-term credits, they ensure that only the top quality companies issue securities, thereby enhancing confidence and stability. However, one effect of this system is that it tends to create an extremely thin market that disadvantages the weakest issuers—i.e., small and new companies. Moreover, the close relationships between financial and nonfinancial corporations which characterize the universal provision of financial services raise a number of concerns about controlling the spread of financial problems or failures. Ownership and control of corporate stock by German banks has come under increasing criticism in recent years for these and the other reasons discussed previously.

Finance and corporate governance in the German system

Bank ownership of companies is an integral part of the German system. There are four types of permitted participation in corporate governance: (1) outright ownership; (2) stockholding; (3) proxy holding, which means a customer of the bank has put stocks on deposit with the bank and permits the bank to vote the stock; and (4) loaned proxy holding, whereby one bank can lend its voting rights in stock to another bank.[63]

Bank participation in German corporations has resulted in greater capital and corporate concentration than in the United States. Since 85 percent of all privately held shares are on deposit with banks, the ability to vote stocks on deposit with the bank by proxy is a potentially potent weapon for consolidating control.[64] In 1980, banks voted an average of 63 percent of the shares of 74 of the nation's largest corporations at annual meetings. The three largest banks alone accounted for 36 percent of the shares voted. And banks vote 70 percent of the shares of the 425 largest corporations which account for three-fourths of the value of all issues on the stock exchange.[65]

---

[62] "Watch on the Rhine", *op. cit.*, p. 122. Comments by Dr. Gunther Mecklenburg, Director of Berliner Handels-und Frankfurter Bank.

[63] *Monetary Policy, Selective Credit Policy, and Industrial Policy in France, Britain, West Germany and Sweden*, staff study of the Joint Economic Committee, Congress of the United States, June 26, 1981, 97th Congress, 1st Session, p. 117.

[64] *Ibid.*, p. 117.

Each tier of the stock control arrangement is under fire. The first two (wholly-owned subsidiaries and stock ownership by the banks) face proposals to limit ownership by any bank in any one company and to set overall limits on nonbank ownership by any one bank. The third and fourth tiers were addressed by the Gessler Commission which suggested that rules of conduct be established to guide banks in proxy voting and that all proxies loaned by one bank to another be made public.

The second area of major controversy with respect to the relationship between banks and business revolves around bank directors sitting on (and often chairing) business supervisory boards. Of the top 400 companies, 318 have bankers on their supervisory boards. Banks control 15 seats as board chairmen of the 100 largest German companies.[66]

Despite the universal banks' aversion to the risks associated with involvement in securities underwriting while engaged in commercial lending, the German banks' entanglement with corporations as shareholders poses risks that may be just as troublesome. The financial problems of a private company to which a bank has made loans and in which it has invested can magnify the financial problems of the bank as well. For example, the recent $190 million rescue of Schroder Munchmeyer Bank raised a number of questions because of the bank's excessive, high-risk loans to an industrial borrower.[67] The bank, with $830 million of assets, had high-risk loans of $303 million outstanding to a group of borrowers close to a construction machinery group, IBH Holding A.G.; was a major industrial shareholder in IBH with a 7.5 percent stake; was a major lender to IBH and one of the bank's senior partners was on the supervisory board of IBH.[68] Several days after the rescue of Schroder Munchmeyer, IBH Holding sought court protection from its creditors.

As noted, the universal banking system received much of the credit for the German economic miracle in the postwar era. Clearly, the extension of credit by the universal banks played a role in rebuilding the country after World War II along with private credit from the United States and U.S. government loans made under the Marshall Plan. Nevertheless, the forward movement of the German economic machine appears to have slowed in the 1980s. Its ability to respond to external economic pressures—the world recession and declining international trade, high oil prices, changing currency values and Third World debt—seems to have weakened. Germany is faced with its highest unemployment rate in many years and the rate of economic growth has declined significantly.

---

[65] *Ibid.*, p. 118.
[66] *Ibid.*, p. 119.
[67] "German Banks in Uneasy Mood", *op. cit.*, p. D9.
[68] *Ibid.*, p. D9.

Perhaps the German economy has matured, after a rapid rebuilding that peaked in the 1970s. But the fact that approximately 60 percent of the German economy's finance depends on the banking sector[69] and that the country's economic growth has been so closely associated with the structure of its financial system in the past raise important questions about the extent to which the universal banking system has had a bearing on Germany's recent economic slowdown.[70] The universal banking system may not be compatible with strong economic growth under all conditions and circumstances.

Moreover, the German universal banking system may have certain disadvantages as a model for the United States. There is no evidence that suggests the German financial system is less sound than the American system. However, the degree of concentration of banks' resources in individual German companies constitutes a threat to soundness that reinforces their risk-averse attitude toward lending to small companies and emerging industries. U.S. economic growth and job creation historically have relied heavily on small and innovative businesses and on the prevalence of small and regional financial institutions that meet their capital and credit requirements. The fact that the German financial system does not meet the needs of this sector and that small business is a proportionately weaker sector of the German economy is seen by some as a factor in its slowdown and the rising rate of unemployment.

In summary, the traditional strengths of the U.S. financial system—its diversity, the multiplicity of choices of financial instruments for both borrowers and investors, the impartiality of institutions in making credit decisions that results from a structural and regulatory framework that requires diversification and prohibits conflicts of interest and concentration—are not the strengths of the universal system. And the introduction of such a system in the United States could have a significant impact on the structure of the U.S. economy.

---

[69] Stewart Fleming, "Coming to Terms with a Changing Banking World", *The Banker*, January 1982, p. 98.

[70] The drag on employment and upward pressure on interest rates that result from the high cost of the public sector are also seen as factors contributing to economic stagnation in the Federal Republic. Some analysts also call attention to the rigid management style that characterizes many German corporations.

CHAPTER 3: THE CHANGING FINANCIAL ENVIRONMENT

INTRODUCTION

Changes in financial structure and regulation do not occur in a vacuum. Economic developments elicit changes in the financial environment that, in turn contribute to further economic change and perpetuate the process in a complex series of interactive responses. The amount of change in the U.S. economy that has occurred in the last fifty years has necessarily forced adaptive responses on the part of financial institutions and resulted in a financial system that has evolved beyond the boundaries set by legislation enacted in the context of economic conditions that no longer apply.

Obviously the economic environment of the 1980s differs markedly from that of the 1930s. Over the last decade, a rising rate of inflation had as great an impact on the financial system as on the economy itself. As nominal interest rates rose in step with the rise in prices, investment patterns shifted and savings were rechanneled to different financial sectors and markets. As will be discussed below and in other sections of this report, these shifts in financial flows altered both the institutional and regulatory framework.

For example, the development of money market mutual funds was not only an attempt on the part of securities firms to exploit opportunities to avoid interest rate ceilings on short-term bank deposits, it was also an effort to recapture business lost as investors shifted funds away from the long-term capital markets. Eventually, repeated bouts of high nominal interest rates forced the abandonment of interest rate ceilings on deposits as a regulatory tool with additional, profound repercussions for both the institutional and regulatory framework of the financial system. Nevertheless, the ways in which the financial system adapted to changes in the macroeconomic environment provided a primary channel for transmission of their effects to the economy as a whole.

Technological innovation has had similar repercussions for financial structure and regulation. It, too, has changed the institutional framework and, by integrating markets previously separated by geography and differences in regulatory treatment, has made the existing regulatory framework less applicable and less effective. The internationalization of financial markets—made possible by advances in communications systems—provided a stimulus to further institutional innovation. But the growing interdependence of national and external markets intensifies the effects of changes that originate in the domestic financial system and the domestic economy. It may also have important effects on attempts to inaugurate changes in domestic markets as, for example, in the case of the 1975 Congressional mandate to develop a national market for securities. Regulations that were applicable to segregated or insulated financial sectors in a geographic framework that focused on the nation—or, in the case of banks and insurance companies, on the individual state—as the primary field of operations are obviously less applicable to multinational institutions operating through global networks.

The internationalization of financial markets also impacts on the ability of the monetary authority to influence financial and economic developments in the domestic market. Open markets are necessarily more vulnerable to external shocks. But the juxtaposition of a regulated and unregulated market for dollar assets—the domestic and Eurodollar markets respectively—may cause, as well as facilitate, the transmission of shocks. The frequency of abrupt and unpredictable shifts in international capital flows exerts a potent influence on U.S. financial markets—one that contributes to volatility and exacerbates the instability of the financial and economic environments.

Despite evidence of these other momentous developments, many observers nevertheless argue that changes in U.S. financial structure primarily reflect changes in consumers' demand for financial services. The final section of this chapter attempts to examine this assertion which, like so much of the debate on financial restructuring, is too simplistic. Changes in strategies, products and functions of financial intermediaries have tended to focus on gathering funds—an objective that primarily benefits the intermediaries themselves and more affluent depositors and investors whose funds they seek—rather than on improving mechanisms for a more balanced distribution of credit. So little attention has been paid to the needs of borrowers by those who press for more (and a more rapid pace for) change that the consumers' purported role as *deus ex machina* in an evolutionary process loses some credibility.

This chapter discusses the ways in which such factors as the macroeconomic environment, technological change, the internationalization of financial markets and changes in customers' demands for services have impacted on the financial system over the last decade. It also describes some of the economic effects that may have resulted from the financial system's responses to change. It is well beyond the scope of this report to offer a complete discussion of these issues or to offer more than tentative hypotheses about the causes and effects of financial institutions' responses. The intention is to suggest that, however complex this aspect of the subject may be, it is important to develop a more complete understanding of how the financial and economic environments interact as part of the process of assessing the need for, and results of, changes in financial structure and regulation.

THE MONETARY AND FISCAL ENVIRONMENT

Since financial structure and regulation do, in fact, interact with fiscal and monetary policy to influence credit allocation and economic activity, it is important that their effects be understood and that they be consistent with the objectives and priorities of economic policy. Current discussions of the effects of the monetary and fiscal environment on the economy tend to ignore financial structure and regulation. The actual and potential impact of rising and sustained federal deficits on credit flows and interest rates appears overwhelming. As Professor Benjamin M. Friedman observed:

> If the U.S. economy is saving 7 percent of its GNP, which is approximately what we have saved for many years now on a net basis, and if the Federal Government's budget deficit is approximately 6 percent of the GNP even at full employment, so that only 1 percent of the economy's output is left over for other uses, the extent to which changes in financial regulation could enable us to use that last remaining 1 percent more efficiently simply is not going to make the kind of difference to be made by freeing up the bulk of the other 7 percent to be used for net investment in housing and in plant and equipment.[1]

This view, of course, reflects what would happen in a closed economy in the absence of globally integrated financial markets. What has actually happened as a result of the Federal government's absorption of so large a share of U.S. savings is that pressure from unmet private demands for credit raised real rates of interest and attracted a huge volume of foreign savings. Although financial structure and regulation played an important role in integrating the domestic and external credit markets and thus enhancing the ability of the United States (and other countries) to augment the domestic credit pool,[2] concerns about the negative impact of future deficits on the economy and the ability of the United States to meet its credit demands from foreign sources have overshadowed perceptions about the importance of financial structure and regulation as factors in the financial environment and as influences on economic activity. How important these factors can be under different fiscal and monetary conditions is more apparent in the context of developments over the last decade.

THE INTERACTION OF MACROECONOMIC AND FINANCIAL DEVELOPMENTS IN THE 1970S

Inflation—whatever its cause—was certainly the dominant influence on financial markets and the economy in the 1970s. Rising rates of inflation, accompanied at times by negative real rates of interest, encouraged investor demand for real (as opposed to financial) assets and discouraged long-term investment and capital formation. Nevertheless, financial markets at home and abroad were awash with liquidity, and borrowing—mostly short-term—rose faster than inflation. By 1978 the ratio of domestic borrowing to nominal gross national product (GNP) had soared 100 percent above the average level of the previous decade.[3]

During this period, the share of total credit loaned by thrift institutions climbed rapidly, if cyclically, until high nominal interest rates choked off the inflow of funds late in the decade. Inflation and negative real rates of interest explain the decline in funds raised through new issues of stocks and bonds and in the corporate sector's share of total credit. Some of the adverse economic effects of that decline are discussed in Part II of this report, as are the adaptive responses of financial intermediaries in offering new, innovative short-term instruments.[4] But it is equally important to note that inflation and negative real rates of interest alone do not explain the behavior of mortgage markets. Assessing developments in these markets would require a broader analysis of the interaction of monetary policy, tax policy, financial structure and regulation, and government credit programs as influenced by inflation and negative real rates of interest.

---

[1] Testimony of Professor Benjamin Friedman, Harvard University, *Future of Financial Markets*, Hearing before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., July 14, 1983, Serial No. 98-42, p. 243.

[2] Some of the economic effects of the internationalization of financial markets are also discussed in Part II, Chapter 1 and in Appendices A and B.

[3] See Table 10, Appendix B.

Most of the increase in stocks and new issues of mortgages relative to other financial assets in the 1970s is attributed to demand factors based on tax incentives. The deductability of mortgage and consumer interest payments encouraged households to "borrow to buy now" with the expectation that inflation would persist and repayments of principal would be made in cheaper dollars. (Similar reasoning—absent tax incentives—fueled the phenomenal rise in borrowing by Less Developed Countries.) But the explanation falters on the supply side. Who provided the funds for lending? In particular, why did savers continue to pour funds into thrift institutions in return for earnings that failed to match the rate of inflation?

In retrospect, it has been argued that regulatory restrictions and the absence of alternative instruments paying market rates of interest to small savers were responsible for a marked increase in savings flows to thrifts. For example, only large, negotiable CDs appropriate for institutional investors were exempt from interest ceilings. And, for most of the decade, only sophisticated investors were aware of the existence of money market mutual funds.

At this same time, there was a significant decline in individuals' investments in Treasury securities—a traditional channel for small savers in earlier decades—in part because the interest rate on savings bonds was lower than rates on most savings deposits and because the minimum investment in Treasury bills had been raised from $1,000 to $10,000 in the early 1970s. But the rate of increase in holdings of Treasury securities by other sectors—banks, insurance companies, non-financial companies, etc.—also declined in most years in the 1970s and, on average, for the decade as a whole. Since a decline in government debt is clearly not the reason for these developments, explanations must lie elsewhere.[5]

As the share of savings allocated to thrifts rose, the distribution of credit shifted as well.[6] And the changes in financial flows that occurred in this period are associated with important shifts in the composition of economic activity. For example, changes in credit flows in the 1970s contributed to:

an increase in consumption as households used a plentiful supply of mortgage credit for other forms of spending. Because inflows into thrifts rose faster in some years than the increase in the stock of housing and raised the price of housing relative to other prices, households were encouraged to borrow against their rising equity and increase expenditures for other durable and non-durable goods and services.

---

[4] See Part II, Chapters 1 and 4.

[5] One hypothesis, foreign official investment of dollar reserves in U.S. Treasury Securities, is discussed elsewhere in this Chapter and in Appendix A.

[6] See Tables 8 and 9, Appendix A.

a decline in the rate of growth of fixed investment in plant and equipment, in the rate of increase in production, and in productivity. Although rising energy prices clearly played an important role in these developments by eroding corporate profits and thus the availability of internal funds for investment, corporations failed (or were unable) to offset these effects by raising funds for expansion through new equity issues or long-term external borrowing.[7]

an increase in the vulnerability of corporations to changes in the business cycle that contributed to economic instability. Institutional and other sophisticated investors reacted to rising rates of inflation and negative real interest rates by shortening the maturity of their portfolios of private financial instruments.

While corporate borrowing fell as a share of total borrowing,[8] short-term borrowing by this sector rose relative to assets, constraining cash flow and resulting in historically illiquid balance sheet positions. With the subsequent downswing in the business cycle, these conditions tended to make businesses more vulnerable to the threat of bankruptcy and may have intensified recessions.[9]

The imbalance between consumption and investment—caused, at least in part, by changes in credit conditions—may have had further interactive effects as well. As the economy's supply of goods and services fell relative to consumer demand, there was an increased tendency to import. And as the share of imports in domestic sales rose, incentives for investment declined.

In view of these developments, it could be argued that the contribution to economic stability of a framework for financial structure and regulation that interacts with other government policies to encourage a flow of funds to housing (or other non-tradable goods) may diminish in a period of declining international competitiveness and rising trade deficits. Even measured against the goal of increasing the stock of housing, government support through tax and regulatory policies and direct and indirect lending programs was less effective as the monetary and fiscal environment shifted. Figure 1 shows dramatic increases in housing starts in 1971-1972 and in 1976-1978, and equally precipitous declines as the economy moved into recession. Obviously such volatile movements were associated with an increase in bankruptcies in the building industries and sizable losses to institutions that provide loans to builders. Figure 2 shows the effects of these developments on additions to the stock of housing. The number of new housing units completed at both the peak and trough of the business cycle fell below the level of the previous cycle as the decade progressed.

---

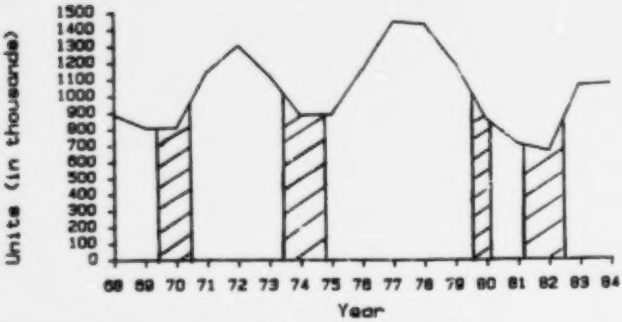
[7] See Part II, Chapter 4.

[8] See Table 9, Appendix A.

[9] These developments are also discussed in Part II, Chapter 4.

FIGURE 1: HOUSING STARTS

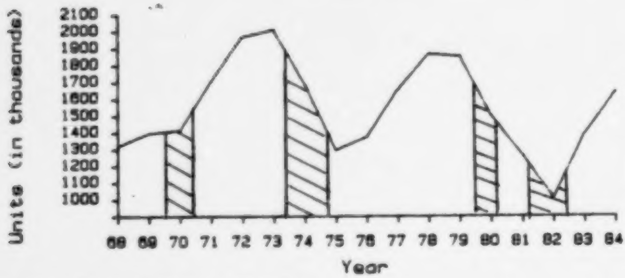
Privately-owned, Single Family



Source: Census Bureau, Construction Starts Branch

FIGURE 2: CHANGES IN THE STOCK OF PRIVATE RESIDENTIAL (1- TO 4-FAMILY) HOUSING

NEW UNITS COMPLETED



Source: Federal Reserve Board

DURATION OF RECESSIONS *	# OF MONTHS
Dec 1969 - Nov 1970	11
Nov 1973 - March 1975	16
Jan 1980 - July 1980	5
July 1981 - Nov 1982	16

* Shaded areas on Figures 1 and 2.

BEST COPY AVAILABLE

Not only were previous mechanisms for increasing the flow of funds to housing ineffective in promoting economic stability, more recent adaptive responses offer little hope for improvement. The regulatory framework for channeling savings and credit to the housing sector was at least partially dismantled in 1982 and the role of government and government-sponsored agencies and mortgage pools in creating secondary markets for financing mortgage credit increased. As discussed elsewhere,[10] this shift in financing mechanisms has exacerbated, rather than alleviated, imbalances in credit flows by reducing the corporate sector's access to long-term capital markets. Achieving the larger goal of economic stability may require a reassessment of allocative mechanisms as well as the priorities they reflect.

TECHNOLOGICAL CHANGE

Given its jurisdiction, the Subcommittee on Telecommunications, Consumer Protection and Finance is fully aware of the dramatic advances in communications and information technologies that have been brought about by the advent of competition in the telecommunications industry. As one of the dominant users of communication and information services in the economy, the financial services industries have been primary beneficiaries of new technologies. The more competitive telecommunications environment has resulted in advances in communications and information technologies that have changed corporate financial planning and the internal operating procedures of financial institutions, resulted in more rapid (and volatile) investment flows, significantly increased the linkages between financial institutions and markets at home and abroad, and eroded the effectiveness of geographic restrictions on the operations of depository institutions—developments that have substantially altered the structure of the U.S. financial system. While many of the innovations result in increased convenience to users of financial services, they have also raised new problems, particularly in the areas of consumer protection, the soundness of financial institutions, and monetary control.

On the other hand, computerized communications systems improve the ability of regulators to conduct market surveillance and identify actual and potential problems. But the effectiveness of surveillance depends on the willingness of regulators to bear the costs of installing and upgrading systems. And cost is a factor that limits the utilization of technology within the industry itself. Some systems require cost-sharing and have raised important questions about access, competitive advantages and actual or potential oligopolistic dominance in markets.

Impact on securities markets

The use of new communications and information technologies has dramatically increased both operational and regulatory efficiency in the securities industry. The quality and timeliness of information have always been especially important determinants of efficiency in these markets where, until recently, transactions costs included the costs of information on the price and merits of individual securities as well as personal advisory services. Nevertheless, the securities industry was slow to upgrade its facilities until specifically mandated to do so by the 1975 amendments to the Securities Exchange Act. These amendments addressed the problem of a growing number of incompleted trades which were the result of a "paper crunch" caused by a reluctance to invest in automated facilities. The requirement to upgrade facilities has greatly increased the ability of securities firms and markets to handle an expanding volume of trading.

---

[10] See Part II, Chapter 4.

In addition, Congress mandated an end to the system of fixed commissions (which resulted in an "unbundling" of transactions and other costs that has had other repercussions for the structure of the industry) and directed the SEC to assist in creating a national market system. While this latter goal has by no means been attained, the concept of a national market system is closely linked to advances in telecommunications and information technologies. Movement away from a market "floor" also depends on such innovations and the growing importance of alternatively structured markets attests to the fact that changes in market structure have been substantial.

The National Association of Securities Dealers (NASD)—a self-regulatory organization responsible for regulating the over-the-counter market—facilitates trading activity for its members "through the use of a computerized communication system which stores up-to-the-second price quotations from a nationwide network of dealers for more than 3,600 over-the-counter securities."[11] NASD also uses the system to monitor trading in the over-the-counter market. The various stock exchanges have also made use of new communications systems to reduce the time required to execute and record transactions and improve their ability to monitor trading. The use of innovative technologies by self-regulatory bodies points up the advantages of sharing costs in industries where there is a commonality and a significant degree of interaction. It also demonstrates the advantages of having a regulatory input into the system both in terms of insuring access and equalizing competitive advantages, as well as facilitating the administration of rules and regulations necessary for maintaining orderly markets.

While the development of market systems that rely on computerized telecommunications and information systems provides obvious benefits in terms of efficiency and improvements in regulation, it has the potential for creating other regulatory problems. A significant volume of negotiated trading could move outside structured markets.[12] The possibility that there could be a growth in com-

---

[11] *Survey of Investor Protection and the Regulation of Financial Intermediaries*, Study by the Staff of the U.S. General Accounting Office, July 13, 1983, p. 24.

NASD's membership includes virtually all exchange members that deal with the public and totaled 3,196 main and 8,320 branch offices of member firms as of October 31, 1981 (*Ibid.*, p. 23).

[12] The U.S. government securities market is an example of an unstructured market dominated by a small group of market participants. Although it is now the largest and possibly the most important market in the world, the majority of underwriting and trading activity is conducted by 36 primary dealers that are regulated and supervised by the Federal Reserve Bank of New

Continued

pletely private transactions that are not reported to an organized market or exchange would have important implications for the public nature of securities markets and their regulation.

Role in the development of international markets

Evidence of the effects of such problems is illustrated in international foreign exchange markets which are dominated by large banks, unregulated brokers and a few large multinational corporations. The absence of reporting requirements in these markets makes it difficult to assess the volume of trading[13] or the nature and extent of irregularities in trading practices. Interviews with banks that are not in the top tier elicit complaints of oligarchical behavior resulting in limited access or discriminatory pricing. Regulatory surveillance is minimal and markets frequently become disorderly, requiring large off-setting commitments of resources by central banks in countries where the volatility of changes in exchange rates has significant effects on national monetary and economic policies. At least two bank failures with widespread repercussions for other banks—Franklin National Bank and Herstatt in 1974—can be attributed to lack of information about these banks' currency transactions on the part of their trading partners and bank regulators in all the foreign exchange markets in which they operated.

The same kinds of technological innovations that facilitated the creation and growth of a global round-the-clock foreign exchange market have also facilitated the integration of national and external capital and credit markets.[14] Improved communications and information systems make possible an expanding volume of transactions between banks and customers in different national or offshore markets, and also make possible the enormous volume of clearing and settlements in dollars held offshore through the New York Clearing House payments system. Multinational banks can instantaneously obtain funds in one market for lending in another, as the size of intrabank transactions between banks' home offices and foreign branches and between foreign branches demonstrates. As discussed below, the volume of these transactions now under-

---

York on a voluntary basis. These dealers use a small group of brokers to trade with one another and thus limit access to price quotations.

Regulation of the secondary market for government securities is divided between the SEC (for registered securities dealers) and bank regulators, with a significant number of participants (unregistered, nonbank government securities dealers) that are not regulated. The absence of reporting requirements makes it difficult to assess the size of the secondary market or monitor trading activity. Thus this market is unique in that—despite its size, its importance in terms of the conduct of fiscal and monetary policy and for maintaining liquidity in the financial system as a whole—lack of access, information and surveillance may make it less efficient than more structured markets. The failures of a number of unregulated dealers in the 1980s and losses to customers resulted in legislative proposals in 1985 to regulate the market. However, it is unlikely that the enactment of legislation at this time will address the issues of access and surveillance. (For further discussion of these issues, see *Legislation Regulating Government Securities Dealers*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., June 11, 20, 26, 1985, Serial No. 99-38; and Report to accompany H.R. 2032, Government Securities Act of 1985, 99th Cong., 1st Sess., September 9, 1985, Report No. 99-258.)

[13] Global trading volume was estimated to be $150 billion a day in 1979 (Ian H. Giddy, "Measuring the World Foreign Exchange Market", *Columbia Journal of World Business*, Winter 1979, p. 38). Federal Reserve surveys show daily trading volume in New York amounting to $5 billion in 1977, $23 billion in 1980 and over $50 billion in 1983.

[14] The internationalization of capital markets is discussed in Part III, Chapter 2.

mines policy actions that rely on assumptions about information and market behavior in a single (domestic) market.

Utilization by depository institutions

Other technological innovations have had an equally dramatic impact on the domestic operations of banks and other depository institutions. Automation and information technologies have improved the efficiency of internal and intra-industry operations. Automation has also created significant benefits for consumers by making such services as deposits, funds transfers and access to cash and information on account balances available on a 24 hour basis, and adding bill payments and payroll management to the range of services available. Banking at home through personal computers linking customers and institutions is expected to become a widespread, additional convenience to consumers in the near future.

The ease with which customers can now handle banking transactions by telephone and through automated transfer systems and tellers means that the link between convenience and location has been broken. Geographic restrictions on the location of banks' offices—an important regulatory restraint used primarily to prevent the concentration of financial resources—depends on that link. Banks are still restricted to accepting deposits at offices within a given geographic area (within a single state or, more recently, a regional area composed of several states) and thus cannot fully utilize their existing potential—even without changing the physical location of their offices—to attract deposits nationwide.[15] But they can and do lend nationally through loan production offices and credit card operations, and can readily gather non-deposit liabilities in money markets at home and abroad. As a result, geographic restrictions as a means of preventing the domination of banking markets by large, money center banks have become obsolete.

Implications for money markets

Communications technologies have also been used to create or restructure markets for short-term financial assets such as certificates of deposit (CDs), federal funds, commercial paper, bankers acceptances, repurchase agreements involving Treasury and government agency securities and, as noted, foreign exchange. One result of this change in structure is that depository institutions have become more market-oriented in pursuit of both sources and uses of funds and—at least in the case of larger institutions—have abandoned the passive role inherent in reliance on face-to-face transactions with customers.

The volume of transactions in these short-term near-money instruments has expanded at a more rapid rate than the volume of trading in securities, and trading is conducted in largely unregulated and unstructured markets which—unlike traditional securities markets—are not monitored by federal or state regulators or self-regulatory bodies. The markets for these instruments have drawn a wider range of financial institutions into a network of brokers, dealers, purchasers and sellers.[16] The result has been a significant increase in contact and competition between institutions whose primary financial functions differ and a marked increase in interdependence for the financial system as a whole.

---

[15] Branching authority is a prerogative of the states. Banks are confined to their home states unless there are reciprocal arrangements under law for interstate branching between states. The individual states determine the extent of branching permitted within the state.

Increased interdependence, as former SEC Commissioner Bevis Longstreth has noted, augments the probability that problems in one sector of the financial system will have repercussions for other sectors—that a domino or chain reaction can be set in motion. And, because of a rise in the velocity of transactions made possible by technological innovations, the incidence of occurrence as well as the impact, is greater.[17] The rapidity and volatility of transactions in near-money instruments may also undermine monetary control as it becomes more difficult for the central bank to determine the *average* size, over time, of aggregates which it seeks to influence.[18]

Policy issues

But the use of innovative technologies by depository institutions has raised questions about issues of more immediate concern to consumers as well. Will a shift from currency and paper-based systems threaten the security of funds and the privacy of financial information? Are consumers sufficiently aware of their vulnerability and liability when using electronic financial services and, if not, who has responsibility for increasing their awareness? And finally, will the potential for fraud and abuse that is specific to a technology-based system affect consumer confidence in the payments system?

While by no means all inclusive, this brief summary indicates that advances in communications and information technologies have had an important role in facilitating changes in the structure of the financial system and the way it operates. However, as the increase in the number and importance of instruments and markets that are outside the existing regulatory framework suggests, these changes have in many instances eroded the effectiveness of the existing regulatory framework and made geographic restrictions obsolete.

Opportunities exist for regulators to improve surveillance through wider use of industry-wide computerized communications systems offered directly by federal regulators or through self-regulatory groups, but, except in a few instances, these opportunities have been underutilized. Improved surveillance of markets used by depository institutions as well as by the securities industry will not resolve all the regulatory issues raised by technological innovation, but it may well be seen as a necessary component in a regulatory structure that places greater reliance on market forces.

---

[16] See, for example, the discussion of brokered deposits in Part II, Chapter 1.

[17] Testimony of Commissioner Bevis Longstreth, Securities and Exchange Commission, *FDIC Securities Proposal and Related Issues*, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., June 16, 1983, Serial No. 98-46, p. 124.

Commissioner Longstreth describes the effects of a change in the velocity of transactions as analogous to the effects of an automobile accident on a freeway where everybody is going 60 miles an hour compared with what would happen at a speed of five miles an hour.

[18] A detailed analysis of this problem has been made by Donald D. Hester in *The Effects of Eurodollar and Domestic Money Market Innovations on the Interpretation and Control of Monetary Aggregates*, Social Systems Research Institute Working Paper (Madison, Wisconsin), 1980.

THE INTERNATIONALIZATION OF FINANCIAL INSTITUTIONS AND MARKETS

The impact of an increased degree of global interdependence on the U.S. economy is beginning to be understood. Most of the attention to this development has focused on trade—in particular, the increase in U.S. exports and imports as a share of GNP and the effects of huge deficits in the trade balance on economic growth. But the rise in financial interdependence has been equally dramatic and may have had equally important effects on the U.S. economy.

Evidence of internationalization

The following is a partial summary of evidence of the degree of internationalization of U.S. financial institutions and of the integration of domestic and foreign financial markets: [19]

> By the end of the 1970s, foreign loans accounted for about 25 percent of total U.S. bank loans, up from about five percent at the beginning of the decade. For the largest U.S. banks, foreign loans and deposits account for a significantly higher share of their total outstanding loans and liabilities.
>
> Borrowings by U.S. corporations in the Eurobond market were $6.8 billion in 1981, $14.5 billion in 1982 and $7.3 billion in 1983. Foreign bond offerings by U.S. companies amounted to 24 percent of net issues of domestic corporate bonds sold in the United States in 1981, 45 percent in 1982 and 23 percent in 1983. One-third of all American corporate bonds (a record $14.4 billion) were issued overseas in the first nine months of 1984.
>
> A rising share of U.S. savings is now invested in external dollar assets. In addition to holdings of dollar denominated Eurobonds, new U.S. residents' deposits in the foreign branches of U.S. banks were equal to about 10 percent of total funds supplied in the domestic market in the second quarter of 1981, 11 percent in the third quarter. About 12 percent of the $107 billion net inflow into money market mutual funds in 1981 was invested in Eurodollar CD's. U.S. borrowing from banks in offshore dollar markets also rose during this period. With the recent decline in dollar interest rates however, U.S. residents' deposits in the foreign branches declined (from 39 to 32 percent of total branch liabilities between May and December, 1984). The dollar volume of foreign branch loans to U.S. customers also fell but their share of total loans remained constant (25 percent).
>
> The central banks and monetary authorities of foreign countries accounted for about 60 percent of the growth in foreign holdings of U.S. financial assets in the 1970s—the result of growth in their dollar reserves. From 1971 through 1980, they acquired over five percent of marketable U.S. financial assets

---

[19] These data are drawn from various Federal Reserve Board sources and from Morgan Guaranty Trust Company, *World Financial Markets*, various issues.

(about one-third of which were acquired by OPEC countries and two-thirds by major industrial countries) and about 28 percent of new Treasury issues held outside U.S. government agencies and trust funds. In 1979 they sold $22 billion of Treasury securities, adding significantly to the supply of government debt that had to be absorbed by domestic investors in that year. The scale of investment by these sources fell significantly as nominal and real U.S. interest rates rose and the dollar appreciated because central banks in major industrial countries sold dollar reserves to support their own currencies.

Until recently, private foreigners have not been a major source of inflows into U.S. credit markets. Like many sophisticated domestic investors, they have preferred to hold dollar assets outside the United States in the unregulated Eurodollar markets because the absence of regulatory costs—reserve requirements and deposit insurance premiums—permits Eurobanks to pay higher rates on dollar deposits than are paid by U.S.-based banks. Thus a rise in U.S. interest rates encourages private foreign investors to shift into dollar assets offshore. This results in dollar appreciation. But if foreign investors choose to hold dollar assets offshore, dollar appreciation will not result in sizable capital inflows into U.S. financial markets. Capital inflows through banking channels will rise, however, if there is a decline in foreign demand for dollar loans (as in 1983), if international developments or loss of confidence in Eurobanks prompt foreign investors to place funds in the United States for reasons of safety, or if U.S. domestic borrowing is crowded-out by large Federal budget deficits.

Nevertheless, private foreigners owned about three percent of total marketable U.S. financial assets at year-end 1983 and their holdings were highly concentrated. Over half of their assets were investments in U.S. corporate stocks valued at $97.7 billion.

Total foreign borrowing in U.S. credit markets has risen significantly in recent years. Funds raised by foreigners in U.S. markets were equal to over one-third of the amount raised by the U.S. government in 1980 and over a quarter in 1981, and larger than amounts raised by small businesses, farmers or state and local governments. Foreign borrowing in U.S. markets fell sharply in 1982 but resumed its upward trend in 1983.

Macroeconomic repercussions of internationalization

An indication of the impact of international capital flows on U.S. financial markets is shown in the analysis in Appendix B. This analysis suggests that the development and rapid growth of an unregulated external market for dollars has had a significant impact on conditions in domestic financial markets and on the conduct of U.S. monetary policy. The data show that in most years in the 1970s and early 1980s, international capital flowed *into* the United States when U.S. interest rates were falling—largely the result of foreign official investment of dollars purchased to support a declining dollar exchange rate—and flowed *out* of the United States when U.S. interest rates were rising—largely due to private U.S. and foreign purchases of dollar assets offshore. The actual direction of flows was contrary to textbook expectations and tended to exacerbate, rather than offset, the credit and interest rate effects set in motion by U.S. monetary policy.[20]

But the direction of flows was set in motion, in turn, by regulatory policy—in particular, the juxtaposition of a regulated and unregulated market for dollar deposits that created a bias in favor of private capital flows into the unregulated market. Differences in regulatory costs give Eurobanks a competitive advantage in attracting funds. However, since these differences in competitive advantage arise *within* rather than *between* financial institutions—that is, between the domestic and foreign offices of individual U.S. and foreign banks with offices in both the U.S. and Eurodollar markets—calls for regulatory equality and a "level playing field" have yet to be heard from these players.

The Federal Reserve, however, has made efforts to negotiate joint actions with central banks in other major industrial countries to regulate the Euromarkets. Despite failure to reach an agreement in 1980 on the form such regulation should take, there was a growing perception that the increased size and volatility of international capital flows undermined the ability of the United States and other countries to conduct an effective, independent monetary policy.

The direction of flows shifted in the first half of the 1980s. The persistence of high U.S. real rates of interest relative to rates in other countries sustained the dollar's value relative to other currencies, and the strain on other economies—particularly in the Third World—has put considerable pressure on the financial system and made Eurobanks less willing to lend dollars to finance the balance-of-payments deficits of developing countries. The enormous U.S. balance-of-payments deficits coupled with a high rate of growth were financed by a sizable inflow of foreign-held dollars. Thus the pattern of capital flows in 1983, 1984 and 1985 more closely approximated the textbook model.

Nevertheless, there was growing concern about the potential for disruption caused by the increase in foreign holdings of short-term U.S. financial assets in 1983 and 1984. While this inflow helped finance the federal deficit and moderated its upward pressure on interest rates, it also posed a threat to continued domestic recovery. Federal Reserve Board Chairman Paul Volcker warned that, as the value of the dollar declined because of rising trade deficits, foreign investors were likely to pull funds out of the United States.[21] Given the scale of short-term foreign investment, a shift by foreign investors into assets denominated in other currencies could accelerate the dollar's fall in value and result in a bandwagon effect. The falling dollar would tend to increase inflationary pressures as the value of imported foreign goods rises and could prompt the Fed to tighten money growth. But such a response would only exacerbate the interest rate effects set in motion by the outflow of foreign funds. By reducing the supply of savings that have financed economic expansion in the face of burgeoning federal deficits, foreign outflows could lead to a precipitous increase in interest rates that would inevitably abort that expansion.

---

[20] That is, interest rates will change more rapidly and rise to higher or lower levels (depending on whether the Fed tightens or eases) than would be the case if there were no external market for dollar assets.

[21] "Volcker Sees Investments From Overseas as Threat", *Washington Post*, February 29, 1984, p. C3.

This is one of the more recent examples of the ways in which international capital flows constrain monetary and economic policy options in national economies. As the Fed's proposals for regulating the Euromarkets suggest, these constraints arise in part because of the institutional and regulatory framework for international financial transactions. While the above example is an illustration of an abrupt and unanticipated redomestication of international transactions, it is also an indication of the success of Eurobank strategies for amassing domestic savings for investment in external markets since a major share of inflows were attributable to interbank channels. Thus the behavior of Eurobanks in this and other instances illustrates the way in which financial and regulatory structure influences economic events. And in this case, the scope of their influence is global.

CHANGES IN DEMANDS FOR FINANCIAL SERVICES

Those who argue that changes in demands for financial services have been—and will continue to be—a factor in reshaping the structure of financial markets point out that consumer demand for market rates of interest led to the development of alternative forms of transactions balances outside depository institutions. These instruments—primarily, money market mutual funds and cash management accounts offered by securities firms—eventually forced Congress to acknowledge that imposing a ceiling on bank and thrift interest rates was no longer a viable regulatory tool.

Less frequently discussed is that larger banks had made interest-bearing transactions accounts available to their commercial customers in the late 1960s by issuing negotiable certificates of deposit and arranging repurchase agreements for the investment of cash balances. It was in the interest of banks to offer these services (and to phase out the use of compensating balances in connection with commercial loans) because reserve requirements on large CDs were lower and repurchase agreements—which for years were aggregated with bank-related federal funds transactions for reporting purposes—were a growing source of nonreservable funds. Reducing the portion of liabilities that were subject to the higher ratio of reserves required against demand deposits increased banks' earning potential by enabling them to support a larger volume of assets.[22] Thus the initial steps toward interest rate deregulation appear to have been at least partially inspired by banks' attempts to avoid regulatory restrictions as well as by their attempts to accommodate commercial customers' desire for market rates of interest, and were facilitated by technological improvements that made possible more sophisticated cash management techniques.

---

[22] In a letter to the Subcommittee, June 5, 1985, Stephen J. Friedman makes the following observation:

> It seems to me that such a result is par for the course in a regulated environment. More importantly, the late 1960s were the beginning of volatile interest rates and disintermediation, and the unregulated CDs and repos were necessary to permit banks to compete for capital in the corporate and institutional market. I doubt they could have performed their financial function in the economy without some relief from deposit interest rate ceilings.

These developments had the effect of creating a two-tiered market with different deposit rates for consumers versus commercial customers, and for large versus small commercial customers as well. While some depository institutions may have favored offering market rates of interest to consumers, most did not. The fact that thrifts relied on low rate savings deposits to support fixed rate investments in mortgages and small banks benefitted from interest-free accounts helped preserve interest rate regulation long after its adverse effects on depository institutions in periods of rising interest rates and on the housing sector had been made abundantly clear.[23] And because the regulators had sanctioned the lifting of restrictions for commercial customers, the burden of interest rate regulation fell primarily on consumers and on thrift institutions.

The creation of interest-bearing non-insured transactions accounts by securities firms is seen as an attempt to exploit the dichotomy in deposit markets on behalf of the consumer. But securities firms were suffering from depressed profits as investors abandoned long-term asset markets and shifted into short-term instruments such as large negotiable CDs and commercial paper. Money market funds also reflected an effort to retain or recapture some of their traditional customers' business.

These new products were not widely marketed until the late 1970s.[24] They only became a major threat to the continued existence of the thrift industry in 1981 when over $109 billion flowed into money market funds, largely supplied by outflows from thrifts. At that point it was clear that a change in demand for services would result in a major structural change in the financial services industry—and major defaults and an erosion of monetary control as well—if interest rate deregulation were not accomplished in short order.

But, a substantial degree of interest rate deregulation having been accomplished, the subsequent shift in funds back into depository institutions suggests that what the consumer wanted was simply higher interest rates—not structural change. And the movement of securities firms to acquire nonbank banks that offer insured deposits indicates a recognition that consumers prefer to use depository institutions for transactions and savings balances and, given the opportunity to earn a market rate of interest, prefer to have these balances insured. It is true that the proliferation of nonbank banks and their ownership by entities engaged in non-financial activities or financial activities other than depository services will result in structural changes, but these changes will not be the result of a change in demand for financial services. There is no consumer demand for nonbank banks.

---

[23] The FINE (Financial Institutions and the Nation's Economy) Study Discussion Principles argued strongly against using depository institutions as the "whipping boys" of a housing program but argued as strongly that the members of the Hunt Commission and other supporters of interest rate deregulation and expanded powers for thrifts were engaged in "wishful thinking" in supposing that these measures would correct "the wild swings in housing starts that plague the economy" or replace "the large quantity of remaining substandard and deteriorating housing." The FINE recommendations included replacing interest ceilings with tax, loan and reserve incentives for depository institutions originating mortgages on property destined for dwellings for low- and moderate-income owners and renters, thus removing the existing subsidies for upper-income people (*Financial Institutions and the Nation's Economy*, Compendium of Papers Prepared for the FINE Study, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Congress, Second Session, June 1976, Book I, pp. 11–12).

[24] While money market mutual funds were well underway during the period of rising interest rates in 1973–1974, Merrill Lynch only began marketing its Cash Management Account in 1978.

There is, however, substantial demand for one-stop convenience in obtaining financial services. The Federal Reserve Bank of Atlanta found that 50 percent of those responding to a recent survey "considered it desirable to obtain all their financial services at one location". On the other hand, only 28 percent would like to obtain all services from a single firm and an analysis of the services desired by this group indicates that most of the services they want "can already be obtained from a full-service depository institution". Therefore, the survey data suggests that "the general population's current demand for additional product deregulation is not extremely strong." [25]

No doubt other surveys—especially those conducted by the individual financial institutions to justify their particular strategies—show a closer relationship between consolidating products and services in a single institution and customers' demand for convenience. But it is not clear that customers fully understand the underlying issues involved in product deregulation. While convenience is an important issue, it is not the only issue. And the demand for convenience could as easily be met by developing the concept of a financial services shopping mall as a means for providing services in one location. In other words, interest rate deregulation was clearly demand driven; product deregulation is not.

Moreover, it is difficult to determine whether consumers will take advantage of the greater degree of convenience that would result from consolidating financial services in a single institution. There is relatively little past experience to draw on. The liberalization of banking functions after the Bank Holding Company Act Amendments of 1970 had little direct effect on consumers except in the area of credit card operations. In many cases, consumers found it very convenient to consolidate credit card usage and other depository services in institutions with which they had an existing relationship. But the success of the large money center banks in attracting a nationwide clientele for the credit cards they sponsored and the substantial number of relationships between consumers and credit card issuers with whom they have no other financial relationship suggest that convenience will not necessarily enhance a given institution's competitive position.

---

[25] Veronica Bennett, "Consumer Demand for Product Deregulation", *Economic Review*, Federal Reserve Bank of Atlanta, May 1984, pp. 36-37.

In a letter to the Subcommittee, June 5, 1985, Stephen J. Friedman commented:

> I am not sure that [a consumer poll] is the best way to really ascertain what consumers want. Let me use bank brokerage as an example. Consumers undoubtedly couldn't care less whether their bank sells stock—at least in the abstract. But the relatively strong growth of bank discount brokerage transactions attests to the attractiveness of the product. I am sure there is relatively little cross-selling or implied coercion in this area. Banks want to do brokerage because it earns them fee income. Consumers use the product. Why not let the marketplace decide the question whether new services are desirable? The policy analysis, it seems to me, should be as follows:
>
> (a) does the new activity adversely affect the soundness of the bank?
>
> (b) does the new activity present conflicts of interest that cannot be dealt with by regulation?"
>
> "If the answer is negative in both cases, why not let banks offer the service and see if it finds a response among customers?"

On the whole, there is no preponderance of evidence to suggest that—aside from interest rate deregulation—changes in consumer demands for financial services are responsible for the changes in financial structure that have occurred. Financial institutions have not always found it easy to implement technological solutions in the form of new products and services for consumers and, until recently, thrifts encountered considerable resistance to variable rate mortgages. As the recent shift of funds back to depository institutions suggests, the special relationship between these institutions and consumers persists and the adequacy of protection remains a major public concern in selecting financial services.

If market forces have played a role in changing financial structure, not surprisingly most developments in new products and services appear to have been in response to demands from sophisticated borrowers and investors—whether individuals, businesses or other financial institutions—who also appear to be the primary beneficiaries. Given the proliferation of choices, it is difficult to determine whether or not less sophisticated users of financial services—again, whether individuals, businesses or other financial institutions—are sufficiently equipped to select appropriate services. Moreover, they are the least likely to pay for information that is not tied to transactions costs. The benefits to the average borrower and investor from structural changes that focus on gains in competition, efficiency and convenience may be marginal if other traditional goals of financial regulation are ignored.

CHAPTER 4: RESPONSES TO FINANCIAL RESTRUCTURING

INTRODUCTION

While explicit efforts to restructure the financial services industry began in the 97th Congress, the legislation that emerged—the Garn-St Germain Depository Institutions Act[1]—dealt primarily with the problems of thrift institutions. Nevertheless, the result was a speed-up of interest rate deregulation for all depository institutions, and expanded asset and liability powers for thrifts that increased their ability to compete with commercial banks as well as money market mutual funds. As was the case in 1966 when Congress failed to deal with the one-bank holding company loophole, the limited scope of the 1982 Act set off an avalanche of activity by both financial institutions and regulators aimed at exploiting loopholes or liberalizing regulatory restrictions based on current law.

In 1982, the Federal Deposit Insurance Corporation ruled that insured state non-member banks were not subject to the restrictions of the Glass-Steagall Act and thus could form or acquire affiliates to engage in a full range of securities activities. In May, 1983, the FDIC issued a proposal to impose restrictions on the securities affiliates of these banks which was adopted on November 19, 1984. The Comptroller of the Currency contemporaneously approved a joint venture between a bank and a discount broker, ruled that discount brokerage was incidental to the business of banking for national banks, and precipitated a stampede into the newly authorized activity. As discussed, financial institutions took advantage of the shift in the regulatory climate signaled by these and other regulators at both the Federal and state level (and by state legislatures) to accelerate the pace of restructuring.

The reaction of Congress to these developments as indicated in statements by Members of both bodies and both parties reflected a consensus on at least one issue: restructuring should be decided by law rather than by regulation or loophole exploitation. But there was a division of views on what the outcome should be and what should be done until Congress makes that decision.

The legislative proposals introduced in the 98th Congress reflected that division. These proposals and various reactions to them are discussed in this chapter together with proposals introduced in the 99th Congress. While an analysis of bills considered in 1983 and 1984 may appear outdated in the context of more recent developments, the issues and concepts embodied in them continue to form the basis for Congressional, regulatory and industry responses.

---

[1] Public Law 97-320 (1982). This legislation continues the trend begun in P.L. 96-221, the Depository Institutions Deregulation and Monetary Control Act of 1980, which dealt primarily with interest rate ceilings but which also authorized transactions balances for thrift institutions (including credit unions). The Garn-St Germain Act accelerated the process of interest rate deregulation and permitted savings and loan institutions to accept deposits from, and make loans to, commercial customers within certain limits.

EARLY CONGRESSIONAL RESPONSES: 98TH CONGRESS, FIRST SESSION

In the early summer of 1983, a number of bills were introduced that clearly reflected a consensus view in Congress about the need for a more orderly process for financial restructuring. There were three bills that would close the nonbank bank loophole and impose a moratorium on certain activities involving depository institutions and their holding companies; [2] one that would expand the activities of these institutions and their holding companies; [3] a bill to establish a Congressional Commission that would provide information and recommendations to assist Congress in making decisions on restructuring; [4] and a bill that would close the loopholes in current law and require divestitures necessary to return to the status quo ante.[5] Although none of these bills was marked up in Committee, they are, as noted, important milestones in the history of financial restructuring because they introduced most of the issues and options included in subsequent proposals.

The moratorium bills

In many respects, the moratorium bills introduced in the summer of 1983 were similar in terms of both provisions and objectives.[6] The major focus was on closing the nonbank bank loophole by redefining a bank as a depository institution insured by the FDIC.[7] The result would have been to prohibit acquisitions of depository institutions (thrifts as well as banks) by commercial enterprises, as well as acquisitions by other financial firms engaged in activities not permissible under the Bank Holding Company Act. In addition, they imposed a moratorium on the authorization of new activities for depository institutions under state law after January 1, 1983 unless authorized by statute for intrastate performance, and applied Federal savings and loan holding company definitions of permissible activities to unitary as well as multiple savings and loan holding companies. Finally, they proposed putting a brake on interstate acquisitions and branching by depository institutions and their holding companies.

---

[2] S. 1532 (and H.R. 3413 and 3536), H.R. 3499, and H.R. 4506.

[3] S. 1609 (and H.R. 3537).

[4] H.R. 3397.

[5] S. 1682 (and H.R. 3768).

[6] The first moratorium proposal (S. 1532 and H.R. 3516), was drafted by the Federal Reserve Board and introduced by the Chairmen and ranking Minority Members of the Senate and House Banking Committees by request on July 12, and July 23, 1983 respectively. The same bill was introduced by Congressman Charles Schumer (as H.R. 3413) with, however, an expiration date of December 31, 1984 rather than the December 31, 1983 date in the original proposal. The second moratorium bill, H.R. 3499, introduced by Chairman St Germain of the House Banking Committee on June 30, had no automatic expiration date and would have been effective until repealed. The third bill, H.R. 4506, introduced by Chairman Florio of the Energy and Commerce Subcommittee on Commerce, Transportation, and Tourism, was similar to the St Germain moratorium but was more narrowly focused on prohibiting the integration of banking and insurance and securities activities, and proposed the establishment of a commission to evaluate and make recommendations concerning the integration of insurance, banking and securities activities.

[7] The Federal Reserve definition was broader in that it included banks eligible for FDIC insurance while the St Germain proposal applied only to institutions that elect to be insured.

It should be noted, of course, that these similarities applied more to the broad issues than to particulars.[8] In general, the bill introduced by House Banking Committee Chairman St Germain provided a more comprehensive moratorium than did the bill drafted by the Federal Reserve—particularly in terms of retroactivity[9] and, thus, the degree of divestiture that would be required. Moreover, the two bills differed in another important respect: the St Germain bill put a stop to additional regulatory relaxations while the Fed bill permitted the various Federal regulators to further expand the scope of permissible activities.[10] The effect of the Fed bill would have been to keep the ball in the regulators' court rather than return it to Congress as the St Germain bill would have required.

The Treasury proposal

Had the Fed's moratorium bill been enacted and the termination date extended, it could have had the effect of permitting a substantial amount of gradual restructuring to occur under the guidance of Federal regulators with minimal interference from the states. The Treasury proposal[11] appeared to reject that approach, and the Secretary of the Treasury repeatedly voiced the view that these were matters for Congress to decide. But the Treasury bill not only would have authorized a substantially greater degree of restructuring than has already occurred, it also proposed that Congress acquiesce to permitting the Federal Reserve Board to authorize additional activities under a new standard that required only that depository institutions' affiliates be engaged in activities of a "financial nature". The effect would have been to give Congress an initial role in speeding up the restructuring process, while leaving to the Fed, its discretion constrained by the more liberal standard, the role of ratifying the even more far-reaching structural changes that would inevitably follow at the initiative of financial institutions. Thus the financial services industry itself would have determined the final outcome of restructuring.

The Treasury proposal, like the moratorium bills, closed the nonbank bank loophole by redefining the term "bank" in the Bank Holding Company Act as an insured institution.[12] But because it would have significantly liberalized the range of activities permissible for depository institutions,[13] it also would have significantly expanded the range of nondepository institutions eligible to acquire banks or thrifts, making the nonbank bank a less necessary vehicle for the expansion of some non-depository financial institutions into banking.[14] On the other hand, the new Bank Holding Company Act standard would have limited the affiliates of depository institutions to activities of a financial nature. Thus, the Treasury proposal would have had the effect of reinstating the separation of banking and commerce. In that sense the proposal to close the nonbank bank loophole was meaningful.[15]

---

[8] For a more comprehensive discussion of these bills and their differences, see Raymond Natter, *Legal Analysis of Proposals to Place a Moratorium on Certain Banking Activities*, Congressional Research Service, American Law Division, July 20, 1983.

[9] Both bills were technically effective when enacted but the limitations and restrictions in the St Germain bill applied retroactively to January 1, 1983 while those in the Federal Reserve bill were retroactive to June 23, 1983.

[10] As a Congressional Research Service analysis of these bills states:

> The House bill and the Fed proposal—take two different approaches to the question of new activities of existing depository institutions and holding companies. The House bill seeks to freeze the permissible activities of all depository institutions and holding companies to those permitted as of January 1, 1983, unless expanded by statute. The Fed proposal only applies such a restriction to state chartered institutions, and only applies to activities commenced after June 23, 1983. Further, under the Fed proposal, banks, bank holding companies, and other institutions could engage in additional activities pursuant to the regulations and orders of the appropriate regulatory agencies, and no prohibition is placed on stock brokerage activities." (Natter, *op. cit.*, p. 19.)

[11] S. 1609 and H.R. 3537, entitled the "Financial Institutions Deregulation Act" or "FIDA".

[12] The Treasury bill used the same definitions as the Fed moratorium bill.

The Financial Institutions Deregulation Act proposal contained a number of other important provisions that can only be noted in passing, within the scope of the present discussion.[16] The more controversial of its proposals included changes in the permissible activities of multiple and unitary savings and loan holding companies that would have reduced the competitive advantages they now enjoy over bank holding companies; provisions permitting bank holding companies to acquire control of one or more thrift institutions (or vice versa); and provisions denying judicial review to those wishing to challenge Federal Reserve Board approval to engage in financial activities.

The effect of this latter provision would have been to give the courts a say in regulatory decisions affecting the structure of the financial system only when, in denying an application, the Fed is believed by the applicant not to have been sufficiently liberal in its determination of the appropriateness of the activity.[17] Since a nonbank competitor could not seek judicial review of a Board decision, this provision would have had the effect of further encouraging a very liberal interpretation of the new standard.

The radical nature of the Treasury proposal was somewhat disguised by the limited "first steps" approach to the integration of banking and securities activities and its attempts to insulate the business of banking by requiring that all nonbanking activities of banks and thrifts be conducted by the holding company or its nondepository subsidiaries and affiliates. The issue of the effectiveness of this form of insulation is discussed in Part II, Chapter 2 of this report. The primary issue, however, is that this proposal, if enacted, would have fundamentally altered the structure of the financial system. Its impact on the way the system operates would have been far greater than what has been implied by developments to date.

---

[13] The bill would have explicitly and immediately expanded the range of activities permissible for nonbanking affiliates of depository institutions' holding companies to include dealing in and underwriting municipal revenue bonds; sponsoring, managing, controlling and advising investment companies and underwriting their securities; engaging in insurance underwriting or brokerage; engaging in real estate investment, development or brokerage and other activities currently permitted for multiple savings and loan holding companies.

[14] The immediate beneficiaries would have been insurance companies, discount brokers, mutual funds, and a wide variety of companies engaged in real estate activities. In time, any company engaged in any financial activity could have owned, or been owned by, a bank.

[15] The bill would have, however, "grandfathered" acquisitions of nonbank banks made before July 1, 1983 whether owned by financial or non-financial companies.

[16] For a more comprehensive discussion of this proposal, see Raymond Natter, *Preliminary Analysis of the Legal Effect of Treasury's Banking Deregulation Proposal on Bank and Thrift Holding Companies*, Congressional Research Service, American Law Division, August 12, 1983.

[17] The Treasury proposal deleted the net public benefits test currently applied by the Board and provided that the Board could consider such factors as managerial and financial resources, independence and impartiality and safety and soundness, but would not be required to do so (*Ibid.*, p. 10).

But the Treasury provided little or no analysis of what the structural or economic implications of its proposal would be by way of justifying so radical a change. Instead, it presented the legislation as a means for equalizing competitive opportunities among financial institutions—or, to repeat the often repeated buzz words, "leveling the playing field." Such a position implies that financial structure has no economic significance—that it is of interest only to financial institutions themselves and not to those who use those institutions to make transactions necessary for the conduct of economic activity.

The Capital Markets Commission bill

The more than 70 cosponsors of H.R. 3397, the bill to create a Commission on Capital Markets, held a different view. This bill identified what its cosponsors considered to be a fundamental danger for the nation's economic future—the unavailability of sufficient long-term capital and credit needed for capital formation at reasonable rates of interest—and proposed that a high level commission be convened to explore the ways in which changes in financial structure may have contributed to creating the problem, and what further changes might be needed to alleviate its effects in the future.

Moreover, the Capital Markets Commission bill raised another issue about which the various deregulatory proposals were silent: namely, the issue of the fragility of the financial system. In an outline of the topics to be explored by the Commission, the bill directed that high priority be given to such issues as safety and soundness and the protection of depositors and investors in making recommendations for changes in financial structure. Finally, it also required that recommendations for changes in financial and regulatory structure take into account the needs of those who depend on financial institutions for the conduct of economic activity, both by including representatives of these sectors on the panel and requiring consideration of such issues as access to capital and credit, the diversity of sources of capital and credit, and the merits of various regulations and other forms of government intervention that affect their allocation.

In summary, the Capital Markets Commission bill differed fundamentally from the Treasury bill in terms of the goals and basis for financial restructuring. It viewed prospective changes as a means for strengthening the financial system and improving economic performance. Moreover, it reflected a concern voiced both within and outside the Congress that these and related goals have been given short-shrift in the debate on the various proposals considered so far. Therefore, it proposed a process that would give greater and wider visibility to these issues and bring together all the views necessary to form a consensus for a decision by Congress. The fact that nonfinancial sectors had been largely excluded from the process of formulating and debating current proposals, and that the focus had been on dividing up shares of the financial pie, was seen by proponents of the Commission as an indication that serious consideration of the issue of financial restructuring had not yet begun.

The Isaac bill

The final bill in this series was drafted by Chairman Isaac of the Federal Deposit Insurance Corporation[18] This bill closed the nonbank bank loophole in the Bank Holding Company Act as did the moratorium and Treasury proposals, extended Glass-Steagall restrictions to all insured banks as intended by Congress in the original 1933 legislation, and made adjustments in the Savings and Loan Holding Company Act to bring thrifts under similar restrictions. It was not a moratorium bill—there was no expiration date—and it required divestitures without provisions for a retroactive date or for grandfathering. Its effect would have been to return to the *status quo ante* as far as the banking industry was concerned, allowing only the degree of deregulation that has been permitted by statutory changes.

The Isaac bill was remarkable in terms of the conservative and drastic nature of its implications, and because of its source. Chairman Isaac favored a substantial degree of deregulation of financial services firms but, in his letter of transmittal, indicated his concern for the regulatory disarray that had developed in the absence of a rational approach to restructuring. He specifically asked that the bill not be considered until mid-1984[19] and then only if Congress failed to enact a comprehensive restructuring proposal that included the recommendations of the Bush Task Group[20] and proposals for changes in deposit insurance programs that would take into account the greater degree of risk in a deregulated environment.[21] He apparently agreed with those who opposed any moratorium proposal on the grounds that it would tend to delay Congressional action. But he was concerned that, if Congress did not act in 1984, the continued exploitation of loopholes and the more liberal regulatory environment offered by certain states would significantly undermine the Federal regulatory framework and erode the effectiveness of the financial safety net.[22]

---

[18] S. 1682 and H.R. 3768, introduced by request on July 26 and August 3, 1983 by the Chairmen and ranking Minority Members of the Senate and House Banking Committees.

[19] In his statement on introducing the bill, Senator Garn remarked that "The FDIC would really prefer that it not be enacted" (*Congressional Record*, July 26, 1983, p. S. 10890).

[20] The Vice President's Task Group on Regulation of Financial Services, an Administration study group informally known as the Bush Task Group, was formed in December, 1982, to develop a legislative program for reorganizing the Federal regulatory structure for financial institutions. The Task Group has issued its report (*Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services*), however it has not sent legislation to Congress. Therefore, it has not been included in this discussion.

The original outline of issues to be studied indicated the Task Group would deal exclusively with alternative proposals for regulatory reform including agency reorganization, transfer of regulatory authority and elimination of regulatory control over certain activities (Federal Register, February 7, 1983, vol. 48, no. 26, pp. 5705–5707). In the paper submitted to the President, the Task Group proposed to eliminate the FDIC's role in general bank supervision by having the Fed handle state-chartered banks in states with weak regulatory capability, and proposed the creation of an agency within the Treasury Department to regulate all national banks. The Task Group also recommended that state regulatory agencies assume responsibility for many state-chartered banks and savings and loans that were, at the time, under Federal supervision. The appropriate agency would also supervise the banks' parent holding companies, eliminating duplicate regulation, with regulation of large multinational bank holding companies remaining under Federal Reserve jurisdiction. Further streamlining was proposed by regulating banking antitrust and securities issues in one (unnamed) agency rather than five separate ones. The Bush Task Group planned to draft legislation to accompany its report, to submit to Congress for consideration in the 99th Congress. ("Inside the Administration", Vol. 3, No. 21, Oct. 19, 1984, p. 8-10.)

In late 1984 the Bush Task Group issued its report, which emphasized the principle of functional regulation. The proposals outlined in the paper submitted to the President remained basically intact. Additional points to the above description of its proposals include: authority over mergers and acquisitions of depository financial institutions would be transferred to the Department of Justice; the FDIC and FSLIC would be required to establish common capital and accounting standards for the institutions they insure and would be given the authority to vary insurance premiums based on risk. The recommendations in the final report dealt primarily with the banking services part of the financial community. They would strengthen the dual banking system, which, as one analyst commented, ". . . would find less support from those who are concerned about the main problems in the banking system today and the contingent exposure of the U.S. Government . . ." (F. Jean Wells, "The Report of the Vice President's Task Group on Regulation of Financial Services: A Brief Summary and Evaluation", Economics Division, Congressional Research Service, Library of Congress, April 17, 1985, #85-693-E, p. 11).

However diverse these proposals were, the Isaac and moratorium proposals had some elements in common. By threatening divestiture, they were intended to brake the rush to exploit existing loopholes. All three focused largely on the activities and ownership of depository institutions and all three would have had the effect of maintaining a separation between banking and non-financial commercial enterprises, including real estate management and development which were defined as financial activities under the Treasury provisions. The integration of other financial services, such as securities and insurance activities, was not addressed. (The Treasury proposal did not explicitly address this issue either but, by authorizing depository institutions to engage in any activity of a financial nature, it implicitly condoned the integration of other activities as well.)

Finally, by attempting to restrain the chaotic integration of financial services until a more rational framework could be developed, these three proposals implied that—however diverse their restructuring objectives—the goals of restructuring should be consistent with regulatory goals that are broader than merely providing equal competitive opportunities within the financial services industry—a view shared by the cosponsors of the Capital Markets Commission bill as well.

THE LEGISLATIVE STALEMATE: 98TH CONGRESS, SECOND SESSION

As the pace of restructuring accelerated in late 1983 and the early months of 1984, pressure on Congress to act intensified. The Congress responded with several new legislative initiatives:

Chairman Garn of the Senate Banking Committee had introduced a more comprehensive bill than the earlier Treasury proposal on November 18, 1983—the final day of the previous session. Senator Proxmire, the ranking minority Member, also introduced a bill on that date that followed but significantly modified the Treasury proposal. The Committee began a series of ten hearings on this legislation in January, 1984.

---

[21] The Garn-St Germain Act of 1982 mandated that the Federal deposit insurance agencies examine and make recommendations concerning the appropriateness of existing deposit insurance programs in light of the differences in risk associated with different institutions and in view of the implications of deregulation for risk. The agencies submitted studies to Congress in the spring of 1983 and, although their recommendations differ, the common areas examined included variable rate deposit insurance premiums based on risk criteria, the role for private insurance and related shared-risk proposals, and the structure of the Federal financial regulatory agencies (F. Jean Wells, "Financial Stability, Efficiency, and Regulation in Financial Markets," Congressional Research Service, Economics Division, July 1, 1983, pp. 25-26). For a discussion of these recommendations see Part III, Chapter 3.

[22] In his letter of transmittal to Senator Garn dated July 25, 1983, Chairman Isaac stated:

> I want to take this opportunity to reiterate our strong opposition to a moratorium. In our judgment, a moratorium would only serve to perpetuate the current inequities, reward those who have exploited the weaknesses of the existing statutory framework and further delay attempts to come to grips with urgently needed reforms. The enclosed bill would, in our judgment, be far superior to a moratorium should our efforts to enact comprehensive legislation fail.

In April, 1984, Chairman Wirth of the Subcommittee on Telecommunications, Consumer Protection and Finance introduced a broad moratorium bill—H.R. 5342, which included the earlier Capital Markets Commission bill—cosponsored by Energy and Commerce Committee Chairman Dingell and seven Members of the Subcommittee. The Subcommittee held three hearings on its bill, the Florio Moratorium bill and the Treasury proposal in April and May.

On May 24, Chairman St Germain and the ranking Minority Member of the House Banking, Finance and Urban Affairs Committee, Mr. Wylie, introduced legislation (H.R. 5743) to close loopholes in current law and held three hearings on that bill in June, in addition to hearings held on related banking issues in March and April.

What follows is a brief description of these bills and of the stalemate that developed as a result of irreconcilable positions on the part of the House and Senate.

Senate bills

As introduced, the Garn bill[23] encompassed issues contained in eight other bills, including the Treasury proposal.[24] The Treasury provisions expanding bank powers were retained as was the provision altering the "closely related" test in the Bank Holding Company Act discussed above. But the Garn bill went a giant step further along the road toward structural deregulation. While nominally closing the nonbank bank loophole, in practice it would have widened the loophole by adding provisions permitting any financial or nonfinancial company to own a limited purpose "consumer bank" which, like existing nonbank banks, either does not take demand deposits or does not make commercial loans. The effect would have been to ratify the breakdown of the barriers between finance and commerce and hasten the development of financial supermarkets by permitting major commercial and financial holding companies—Sears, J.C. Penney, National Steel, Prudential-Bache, Merrill Lynch, and Shearson/Lehman/American Express, for example—to engage in a full range of financial services and offer insured deposits nationwide. The explicit inclusion of nonfinancial companies in providing banking services and the implicit authorization of interstate banking stamped the Garn bill as a far more radical proposal than the bill drafted by the Treasury.

The Proxmire bill,[25] by contrast, was more modest than the Treasury's proposal. The bill provided that only trust companies would be excluded from the redefinition of bank, and only if substantially all of their deposits were received in a fiduciary capacity. It extended Glass-Steagall prohibitions on underwriting and dealing in corporate securities to state nonmember banks, omitted provisions in the Treasury bill that would have allowed thrifts to engage in securities activities through their holding companies or securities affiliates, omitted real estate powers for banks and limited bank holding companies' insurance powers to those permitted under Garn-St Germain (1982), included provisions from the moratorium bills limiting the ability of states to liberalize activities for Federally insured state chartered banks and thrifts, and placed additional restrictions on thrifts owned by unitary thrift holding companies to prevent nonfinancial firms from buying thrifts to gain access to the payments system. In one respect, however, the Proxmire bill went beyond the Treasury proposal by expanding the new securities powers authorized for banks to include underwriting and dealing in mortgage-backed securities.

---

[23] S. 2181.
[24] S. 1609 and H.R. 3537, discussed above.
[25] S. 2134.

In view of the scope of the Garn bill, the legislation subsequently reported by the Senate Banking Committee[26] was significantly narrower and less radical, with many modifications reflecting policy positions contained in the Proxmire bill. The Committee dropped the "consumer bank" provisions and, by retaining the loophole-closing section of the bill, reaffirmed existing prohibitions against combining commerce and banking. It also reaffirmed the right of the states to authorize or prohibit branching by out-of-state banks, including the right to form regional interstate banking compacts. In addition, the Committee modified the proposal to alter the "closely related" test to include all activities of a "financial nature"—a proposal that, as discussed above, would have empowered the Federal Reserve Board to expand banks' powers beyond those explicitly authorized by Congress.

The Committee also limited the scope of the new powers authorized for banks under the Garn bill as introduced. It accepted an amendment offered by Senator Dodd extending the limitations on banks' insurance activities in the Garn-St Germain Act (1982) to depository as well as non-depository affiliates of bank holding companies; dropped the provision authorizing expanded real estate powers and deleted the authorization for banks to sponsor and manage mutual funds from the provisions authorizing new securities powers.

Nevertheless, the final version of the bill adopted by the Committee and passed by the Senate on September 13 broadened the "closely related to banking" test in the Bank Holding Company Act and gave banks and thrifts substantial new powers in the area of securities activities. The legislation authorized the creation of "Depository Institutions Securities Affiliates"—separate subsidiaries of bank and thrift holding companies—which could underwrite and deal in state and local government revenue bonds, mortgage-backed securities and commercial paper and engage in discount brokerage, acting as agents in buying and selling corporate securities for customers.

The House Banking Committee bills

The House Banking Committee bills[27] were essentially loophole closing bills and their major features are described in the comparison of the House and Senate bills below. The initial version of the legislation (H.R. 5743) contained no grandfather provision for nonbank banks, had more restrictive provisions relating to "qualified" thrifts and would have prohibited bank and thrift involvement in discount brokerage.[28] Many viewed the addition of the grandfather provision as the most significant change made by the Committee in the course of its consideration of the legislation. Like both the Senate Banking Committee and the Subcommittee on Telecommunications, Consumer Protection and Finance, the House Banking Committee amended its bill during mark-up to extend the prohibitions against bank involvement in insurance activities under Garn-St Germain to banking as well as nonbanking affiliates of bank holding companies.

---

[26] On June 27, 1984.

[27] H.R. 5743 and H.R. 5916.

The Wirth Moratorium/Capital Markets Commission bill

The Wirth moratorium bill [29] approached the issue of restructuring from an entirely different perspective than that reflected in the Garn bill. It sought to impose a short moratorium (until December 31, 1985) on further combinations of securities, insurance and depository institutions and functions, and on combinations of these financial institutions and functions with commercial firms and activities. Although this bill did not amend existing law, it would have temporarily closed the loopholes in current law as effectively as the earlier moratorium bills discussed above. However, the absence of amendments to banking law in the structure of the legislation reflected its broader purpose: to halt combinations of financial and commercial functions involving nonbank financial intermediaries as well as combinations involving banks.

The concerns that led the Subcommittee to introduce this bill were discussed in its April-May, 1984, hearings and are raised elsewhere in this report. The Subcommittee noted the number and size of recent mergers involving securities and insurance companies, the actual and potential movement of life insurers into other financial and commercial activities and the proliferation of mortgage banking affiliations involving all financial intermediaries. This constellation of developments, combined with product innovation, permitted the creation of a new class of financial conglomerates outside the banking system, offering services that were effective substitutes for bank products in tandem with other products and services. In the Subcommittee's view, these combinations posed a significant threat to soundness because of the increased potential for conflicts of interest and the concentration of financial resources. By increasing the interdependence of the financial system, they could exacerbate the systemic repercussions that had already been apparent in the Drysdale and Silver crises.

The intent of the bill was to halt these developments until Congress could evaluate their impact on the economy and on the soundness of the financial system. The inclusion of the Capital Markets Commission bill discussed above provided the mechanism for the evaluation. Hearings on the bill revealed substantial support as well as opposition to the approach. However, the consensus view in the late spring was that a moratorium would be less desirable than permanent legislation dealing primarily with banking issues. The Subcommittee acknowledged that it would not be possible to address the broader issues without the comprehensive analysis that its bill had proposed, and moved to work in tandem with the Banking Committee to enact the loophole-closing legislation.

---

[28] For a more extensive discussion of the differences between H.R. 5743 and H.R. 5916, see *The Financial Institutions Equity Act*", Report of the Committee on Banking, Housing, and Urban Affairs, U.S. House of Representatives, on H.R. 5916; H.Rep. 98-889, July 12, 1984.

[29] H.R. 5342.

The Energy and Commerce Subcommittee bill

The hearings held by the Subcommittee on Telecommunications, Consumer Protection and Finance indicated strong support both for permanently closing the loopholes in current law and for further analysis of how proposals for additional restructuring would impact on the economy and the existing regulatory framework. In response to their perception of a growing consensus in favor of loophole closing, Chairman Dingell, Chairman Wirth and the ranking minority Member of the Subcommittee, Mr. Rinaldo, cosponsored the St Germain-Wylie bill. In subsequent meetings with Members, it was agreed that the Subcommittee should introduce and act on a bill based on the St Germain-Wylie bill that would also direct various regulatory agencies and departments to provide studies of issues that had been cited as requiring analysis in the Capital Markets Commission bill.

The Energy and Commerce Subcommittee bill[30] included Title I (Congressional Findings) of the earlier Moratorium/Capital Markets Commission bill[31] and a modified version of Title III of that bill.[32] However, Title II, as introduced, was based primarily on H.R. 5743, the bill introduced by Chairman St Germain and Congressman Wylie on May 24. The most notable provisions added to the Subcommittee bill were those expanding the loophole-closing provisions by prohibiting banks to make a public offering of pooled investments in securities (in effect, a mutual fund) to IRA investors, and by imposing a three-year moratorium on Federal regulatory decisions expanding the powers of banks and thrifts to engage in new activities. The Subcommittee argued that the latter provision was necessary to prevent the "discovery" or ratification of new loopholes by regulators that could make the legislation obsolete within a very short period of time.

Several additional provisions were added during mark-up: a grandfather amendment covering only non-federally insured industrial banks, an amendment limiting banks' insurance powers and an amendment preempting state authority to expand banks' powers to institutions with $50 million or more in assets.[33] These amendments were adopted without objection.

Another amendment (offered by Chairman Wirth) was more controversial and was adopted by a vote of 9–6. This amendment would have provided that securities firms underwrite their own securities, or those of an affiliate, or cross-market the products and services of a non-securities affiliate only under rules established by the SEC to prevent conflicts of interest. The amendment also set forth public interest standards to guide the SEC in exercising its rulemaking authority.

---

[30] H.R. 5881, introduced June 15, 1984.

[31] H.R. 5342.

[32] Title III provided that much of the analysis that was to have been developed by the Capital Markets Commission be undertaken by various government regulatory agencies and departments.

[33] These amendments are discussed below.

Opponents of the amendment pointed out that it would expand the SEC's authority by giving the Commission explicit authority to regulate conflicts of interest. In response, Chairman Wirth noted that this authority was symmetrical with that given the Federal Reserve Board and the Federal Home Loan Bank Board in other sections of H.R. 5881 and in the St Germain-Wylie bill. It was needed because of the expansion of securities firms into other financial and nonfinancial activities and because of the failure of the self regulatory organizations (SROs) within the securities industry to adequately address the issue.

In addition to reflecting some of the broader issues addressed in the Moratorium/Capital Markets Commission bill (H.R. 5342), the amendment would have dealt with immediate problems including concerns related to the underwriting of mortgage-backed securities. During consideration of the Secondary Mortgage Market Enhancement Act [34] there had been extensive discussion of proposals to allow banks and thrifts to underwrite these securities. Chairman Wirth and other Members raised questions about the conflicts of interest inherent in combining the business of originating mortgages with that of issuing and underwriting mortgage-backed securities. But the dangers were no less if the institution originating the mortgages were a mortgage banking affiliate of a securities firm (like those affiliated with Dean Witter or Merrill Lynch) than if it were a depository institution. Chairman Wirth argued that the overriding focus on changes in banking activities tended to obscure the scope and significance of the erosion of important regulatory goals—i.e., preventing conflicts of interest and concentration—outside the banking system.

Legislative action in the 98th Congress

The House Energy and Commerce bill (H.R. 5881) was marked-up on June 21 and unanimously reported as amended to the full Committee. On June 22, the Banking Committee introduced H.R. 5916, a somewhat narrower version of the earlier St Germain-Wylie bill, and marked-up the legislation on June 26, reporting the bill as amended by a vote of 32-16. The following day, the amended version of the Garn bill was reported unanimously by the Senate Banking Committee.

Over the summer, there were several additional developments. On June 28, Chairman Dingell sent a letter to Chairman St Germain affirming his support for the bill reported by the Banking Committee (H.R. 5916), clarifying his Committee's jurisdiction over legislation affecting the structure and soundness of the financial system and stating that, if the Senate passed the Garn bill as reported from Committee, he would expect it to be referred to Energy and Commerce as well as to the House Banking Committee. Subsequently, a joint letter was sent by these two chairmen to the Speaker of the House outlining their respective jurisdictional concerns and indicating agreement that any legislation expanding banks' powers into areas not closely related to banking would fall within the jurisdiction of the Energy and Commerce Committee. Meanwhile, the Subcommittee on Commerce, Transportation and Tourism, which has jurisdiction over the insurance industry, announced that it would take action on H.R. 5881 and reported the bill without amendment to the full Energy and Commerce Committee on July 26.

---

[34] S. 2040 (Public Law 98-440, October 3, 1984).

When Congress reconvened in September, the focus was on the Senate. The bill marked-up by the Senate Banking Committee had been introduced in July as S. 2851 and was taken to the floor immediately after the Labor Day recess. Opponents of the bill were successful in delaying consideration until the following week, but were not successful in blocking its passage or obtaining significant changes. S. 2851 passed the Senate on September 13 by a vote of 89–5.

The Senate action changed the outlook for action in the House. The Senate bill dealt with issues such as regional interstate banking compacts and limitations on brokered deposits that had not been considered by House Committees, and Chairman Rodino of the Judiciary Committee asserted his Committee's jurisdiction over the regional compact provisions. This development, together with the fact that the Banking Committee and Energy and Commerce Subcommittees had not approved expanded powers for banks, made it unlikely that the Senate and House could agree on a bill so late in the session. Chairman St Germain announced that he would not take H.R. 5916 to the floor but, in a letter to Senator Garn, suggested that both Houses adopt a joint resolution asking the Comptroller of the Currency to extend his moratorium on approvals of non-bank banks. Senator Garn rejected this suggestion. At the end of the session in October, however, Chairmen Garn and St Germain issued a statement affirming their commitment to enact banking legislation in the next Congress and their commitment to retaining the grandfather dates provided by S. 2851 and H.R. 5916.[35]

Comparison of the House and Senate bills

The legislative proposals acted on by the Senate (S.2851), the House Banking Committee (H.R. 5916), and the Energy and Commerce Subcommittees (H.R. 5881) in 1984 closed the loopholes in current law in relatively similar fashion. All three:

Closed the nonbank bank loophole by redefining a bank (for purposes of the Bank Holding Company Act) as an institution that accepts deposits that are insured or eligible for insurance, and that offers transactions (demand and NOW) accounts and makes commercial loans;

Closed the Glass-Steagall loophole by extending the prohibitions against member bank affiliations with securities firms to nonmember banks and thrifts; and

---

[35] These dates are virtually identical: July 1, 1983 in S. 2851 and June 30, 1983 in H.R. 5916.

Closed the South Dakota loophole created by that state's offering to charter subsidiaries of banks to sell insurance in other states but not in South Dakota.

There were, however, differences in these basic loophole-closing provisions. For example, the Senate bill only closed the South Dakota loophole with respect to insurance. The House Banking Committee and Energy and Commerce Subcommittee bills required that any expansion of bank and thrift powers beyond those permitted under Federal law be conducted only within the state authorizing such powers, and only for residents of that state. But the Energy and Commerce Subcommittee bill went a step further in dealing with the issue of state powers. It provided that only those institutions that were members of bank holding companies with $50 million or less in assets could take advantage of more liberal state laws. This provision reflected the Subcommittee's concern about the proliferation of laws expanding banks' powers that had been enacted or proposed by states.[36] Its purpose was to prevent the undermining of Federal regulatory restrictions that could encourage institutions to switch from Federal to state charters and to protect the Federal deposit insurance funds.

Equally important were differences relating to the grandfather dates in the three bills. The Senate bill (S. 2851) grandfathered nonbank banks approved as of July 1, 1983 and the House Banking Committee bill's grandfather date was June 30, 1983. The Energy and Commerce Subcommittee bill (H.R. 5881) was more restrictive. It would only have grandfathered limited-purpose banks formed three years before date of enactment, would have denied deposit insurance to grandfathered institutions and prohibited the use of funds supplied by non-depository affiliates for the expansion of grandfathered activities. The purpose was to protect some 2,000 so-called "industrial" banks[37] that had been operating for many years without insurance or under state insurance programs, without rewarding loophole exploiters or perpetuating the threat they posed to the Federal deposit insurance fund.

Institutions that had exploited the Glass-Steagall loophole were also treated differently under these legislative proposals. The Senate bill grandfathered their activities using the same July 1, 1983 date while the House Banking Committee rejected a grandfather amendment. The absence of a grandfather provision in the bill marked-up by the two Energy and Commerce Subcommittees reflected the opposition to grandfather provisions voiced by Members of the full Committee.

In addition to these loophole-closing provisions, all three bills would have significantly reduced the competitive advantages enjoyed by "unitary" thrift holding companies—holding companies that own a single thrift institution—compared with those that own more than one thrift institution. The major differences in the bills relate to the definition of a "qualified" thrift. In general, the

---

[36] A more detailed discussion of concerns raised by current and prospective changes in state law is provided in Part III, Chapter 1.

[37] Despite the nomenclature, "industrial" banks are actually consumer-oriented institutions; few make commercial or industrial loans. Most are an outgrowth of the Morris Plan bank movement—banks established to provide services to industrial workers who were unable to obtain services from commercial banks.

House bills were somewhat more restrictive with respect to the amount of assets that had to be invested in housing-related loans and investments, in defining housing-related assets and with respect to the range of activities permitted for both unitary and multiple thrift holding companies.

Clearly these differences in the House and Senate bills could have been reconciled. But because the Senate's bill included expanded powers for banks and addressed issues such as regional interstate banking compacts and brokered deposits, agreement was virtually impossible.[38] The House had only considered issues that related to loophole closing, but that issue necessarily encompassed the question of expanded powers for banks and the entry of other financial and commercial entities into banking. The record of Committee deliberations indicated strong, bi-partisan opposition in the House to combining banking with other financial and commercial activities.

As the following tables show, the new securities powers included in the Senate bill dramatically increased banks' share in underwriting new securities issues. Together with existing powers to underwrite U.S. government issues, state and local general obligation bonds and some portion of revenue bonds, banks would have been able to underwrite all securities issues except corporate issues—all but 25 percent of the total market for new issues. The implications of the expansion of depository institutions into new underwriting activities for the viability of corporate underwriters would appear to warrant some analysis of how this legislation would impact on securities markets and how well corporate issuers would be served under such a structure. Sponsors of the securities provisions in the Senate bill offered no analysis of their potential impact on corporate issuers and appear to have been unaware of how extensive an expansion of banks' securities powers was being authorized.

In any event, these tables graphically demonstrate the concerns underlying House opposition to expanding banks' securities' powers. The Senate bill was not a modest proposal. It would have expanded bank operations in less structured and regulated markets than those in which corporate securities are traded.[39] And it would have significantly increased the interdependence of financial sectors and markets, enhancing the potential for systemic crises resulting from the problems of individual institutions.

---

[38] As noted, the Senate bill was, as its sponsors said, a "comprehensive" bill addressing a number of issues other than the structural issues discussed here. Because of the technical complexity of the legislation, further analysis in the context of this report would not be useful. While the Committee report (*Financial Services Competitive Equity Act*, Report of the Committee on Banking, Housing, and Urban Affairs, United States Senate, on S. 2851; S. Rep. 98-560, July 17, 1984) may be helpful to some readers, it does not include a discussion of the so-called "managers amendments" adopted on the floor which many have argued are substantive rather than technical in nature. Whether justified or not, that view may have contributed to the concerns of Chairman St Germain and other Members of the House that any attempt to reconcile Senate and House bills would require more time than was available so late in the session.

[39] As noted elsewhere, proposals are pending to regulate the Government securities market (which includes Treasury issues and mortgage-backed securities issued or guaranteed by Federal or Federally sponsored agencies). However, state and local government securities are exempt from disclosure and subject to less regulatory surveillance than corporate securities, while the commercial paper market is not subject to regulation. Moreover, all these markets are decentralized and, thus, not subject to monitoring and oversight by self-regulatory organizations such as securities trading associations and national exchanges, or explicit SEC oversight.

TABLE 1.—SELECTED NEW SECURITIES ISSUES

[In billions of dollars]

	1981	1982	1983
Corporate stock issues:			
Common stock	$15.3	$23.4	$38.4
Preferred stock	1.6	5.1	7.7
Total	16.9	28.5	46.1
Corporate bond issues:			
Publicly offered	33.6	36.3	38.3
Privately placed	18.5	26.4	33.1
Total	52.1	62.7	71.4
Subtotal	69.0	91.2	117.5
Commercial paper [1]	25.7	−0.7	3.5
Mortgage backed securities: [1]			
Ginnie Mae	14.3	16.0	50.5
Fannie Mae	0.7	14.0	13.3
Freddie Mac	3.5	20.2	19.5
Conventional	([3])		1.2
Total	18.5	50.2	84.5
State and local issues:			
General obligation bonds [2]	14.0	23.3	22.6
Revenue bonds [1, 2]	35.3	58.0	64.2
Of which, housing bonds [2]	(5.1)	(14.3)	(13.1)
Total	49.3	81.3	86.8
Subtotal	93.5	130.8	174.8
Marketable U.S. Treasury issues [2]	97.1	161.2	183.1
Grand total	259.6	383.2	474.4

---

[1] "Bank eligible" securities under Senate bill (S. 2851).

[2] "Bank eligible" securities under current law. Note. Banks are eligible to underwrite housing, university and dormitory bonds. Statistics are not kept to reflect accurately the "bank eligible" totals included in revenue bonds. However, housing issues are by far the largest segment of revenue bonds that are currently "bank eligible"

[3] Less than $100 million.

TABLE 2.—BANKS' CURRENT AND PROSPECTIVE SHARES OF SECURITIES ISSUES

[Dollars in billions]

	1981	1982	1983
"Bank eligible" securities under current law:			
Excluding U.S. Treasuries:			
Amount	$19.1	$37.6	$35.7
As a percent of total issues	11.7	16.9	12.2
Including U.S. Treasuries:			
Amount	$116.2	$198.8	$218.8
As a percent of total issues	44.8	51.9	46.0
"Bank eligible" securities added under Senate bill (S. 2851):			
Amount	$74.7	$93.2	$139.1
As a percent of total issues:			
Excluding U.S. Treasuries	46.0	42.0	47.6
Including U.S. Treasuries	28.8	24.3	29.3
Banks' prospective share of securities issues ("bank eligible" securities under current law plus additions under S. 2851):			
Excluding U.S. Treasuries:			
Amount	$93.5	$130.8	$174.8
As a percent of total issues	57.5	58.9	59.8

TABLE 2.—BANKS' CURRENT AND PROSPECTIVE SHARES OF SECURITIES ISSUES—Continued

[Dollars in billions]

	1981	1982	1983
Including U.S. Treasuries:			
Amount	$190.6	$292.0	$357.9
As a percent of total issues	73.4	76.2	75.3

Source: (for both tables 1 and 2) Salomon Brothers data on issue volume, compiled by subcommittee staff

The irreconcilable nature of the House and Senate legislative proposals also reflects other, very basic differences in philosophy and focus. The Senate focused largely on the issue of equalizing competitive opportunities—the so-called "level playing field". Like the Treasury proposal, the bill passed by the Senate embodied the view that increasing competition would reduce the cost of credit and that the free-play of market forces would promote soundness and efficiency. House Members were skeptical that the emphasis on increased competition would result in a financial system that could meet other traditional objectives (including soundness and fair and equal access to credit), and questioned whether erasing the barriers between financial functions would actually increase competition given the increased potential for anti-competitive tie-ins, conflicts of interest and the concentration of financial resources.

LEGISLATIVE INITIATIVES IN THE 99TH CONGRESS

At the beginning of the 99th Congress, House Banking Committee Chairman St Germain introduced a bill to close the nonbank bank loophole.[40] This was a narrower bill than that marked-up by the House Banking Committee in the 98th Congress; most notably, it failed to close the Glass-Steagall and South Dakota loopholes. But it reflected a widely shared view that, as developments in the previous Congress had shown, agreement between the House and Senate would become less likely as legislation became more comprehensive. Chairman St Germain's bill focused on the core issue addressed by bills acted on by House Committees and the Senate in 1984—the issue, it was believed, around which a consensus had formed.

As the spring wore on, however, it became clear that the nonbank bank issue was more controversial than had appeared to be the case. The use of the nonbank bank loophole by the larger money center and regional banks to evade restrictions on interstate banking resulted in bitter exchanges between the Independent Bankers Association of America (IBAA) and the American Bankers Association (ABA) and pushed the issue of interstate banking to the forefront of the debate.

Chairman St Germain agreed to address this issue and the legislation was crafted from several proposals during Subcommittee mark-up, on June 5, 1985. The nonbank bank bill was also marked-up by the Subcommittee on Financial Institutions Supervision, Regulation and Insurance and both bills were marked-up and reported out of the Banking Committee the following week, June

---

[40] H.R. 20, introduced January 3, 1985.

12.[41] The following is a brief analysis of these two bills as reported from Committee.

The Financial Institutions Equity Act of 1985

As reported by the House Banking Committee, the Financial Institutions Equity Act of 1985 (H.R. 20), would close the nonbank bank loophole by redefining the term "bank" under the Bank Holding Company Act to be any FDIC insured bank or any institution which accepts transactions accounts and makes commercial loans. Thrifts, credit unions, the U.S. branches of foreign banks, credit card banks and a few other limited purpose institutions would be exempt from the definition.

Nonbank banks grandfathered (allowed to continue to be controlled by their owner) under this bill must have received all necessary agency approvals on or before May 9, 1984.[42] They would be required to register with the Federal Reserve Board and would be subject to its examination and supervision. Grandfathered banks (1) could only engage in activities in which they were lawfully engaged on May 24, 1984, or which the Board deemed to be virtually equivalent to those activities; (2) could not increase the number of locations at which they operated; and (3) could not cross-market products or services of an affiliate engaged in activities not permissible for bank holding companies under the Bank Holding Company Act.

In addition, the Federal Reserve Board was given authority to require the divestiture of any grandfathered bank, or order the cessation of certain of its activities, if the Board determined that it was: (1) violating the restrictions previously listed, (2) impairing the safety and soundness of the Nation's financial system, (3) disrupting the payments system, or (4) that its activities resulted in conflicts of interest, undue concentration of resources, or unfair competition.

H.R. 20 also amended the Savings and Loan Holding Company Act, extending its provisions to uninsured institutions and state-chartered savings banks. The proposed legislation limited the activities and affiliates of a unitary savings and loan holding company to those permissible for a multiple thrift holding company unless the thrift subsidiary in a unitary holding company met the requirements of a qualified thrift lender. Standards for a qualified thrift lender would require that it have 65 percent or more of its assets in residential mortgages or related investments. Finally, the bill restricted the thrift and nonthrift affiliates of a savings and loan holding company from cross-marketing their respective products and services if, in the case of a state chartered thrift or a unitary thrift holding company, its nonthrift affiliates were engaged in activities not permissible for a multiple thrift holding company.

The Depository Institutions Acquisition Act

The second bill reported out by the Banking Committee, the Depository Institutions Acquisition Act (H.R. 2707), would permit bank holding companies to acquire additional banks across state lines if allowed by the states in which the acquired banks were located. However, either by July 1990 or two years after the state had passed its law, any state that had authorized such acquisitions could no longer discriminate in granting additional acquisitions on the basis of location. In other words, the bill ratified regional compacts formed by states but provided a "trigger" date for nationwide interstate banking in those states that had entered into regional compacts.

---

[41] As of this writing, they are pending before the Rules Committee.

[42] This was a significant liberalization of the grandfather date (June 30, 1983) provided in the bill adopted by the Committee in 1984 and in H.R. 20 as introduced.

In response to concerns about the undue concentration of financial resources, the Committee adopted provisions restricting Federal Reserve Board approval of interstate acquisitions if: (1) the acquisition would result in an undue concentration of resources; (2) the applicant holding company and institution to be acquired were both among the 25 largest institutions in the United States in terms of deposits; (3) as a result of the acquisition, the applicant company would hold one percent of total U.S. domestic deposits; or (4) the acquisition violated a state limit on holdings of assets or deposits by individual institutions that was based only on the assets or deposits of that state. The Federal Reserve Board was also authorized to impose additional financial and managerial requirements on a holding company with bank subsidiaries in more than one state to ensure the stability of the U.S. banking system.

Authorization for interstate acquisitions by bank holding companies would also be dependent upon assurances that community benefit requirements would be met, including commitments to provide credit and deposit services, with a similar provision applicable to savings and loan holding companies. In fact, one notable aspect of the bill was that it explicitly authorized interstate acquisitions by savings and loan holding companies. The provisions relating to interstate acquisitions by savings and loan holding companies were very similar to those applied to bank holding companies with two exceptions: neither the concentration of resources provisions nor authority to impose additional financial or managerial requirements were included.

Other provisions of H.R. 2707 prohibited FDIC insured banks from operating branches across state lines, reaffirmed existing authority for emergency acquisitions arranged by the FDIC or the FSLIC under the Garn St Germain Act, extended the emergency acquisition provisions due to expire on October 15, 1985 for three additional years, and deleted the $500 million minimum asset requirement for interstate acquisitions of failing banks or mutual savings banks.

INDUSTRY VIEWS AND RESPONSES

The proliferation of new products and services and blending of functions that has taken place suggests that the financial services industry has uniformly embraced opportunities for restructuring that have been made possible by creative "loophole" lawyers and acquiescent regulators. But these developments reflect the responses of those institutions who have participated in restructuring and necessarily ignore the views of many who have not. The record of Congressional hearings on financial restructuring indicates that the industry is divided on the merits of the issue. Different trade associations (which, like the regulatory agencies, are still organized to represent separate financial functions, products and services), tend to hold different views.

Although some individual (primarily large) firms disagree, the securities industry, through its trade associations, argues that the separation of banking and securities activities should be maintained. The SIA and the Investment Company Institute favored the moratorium bills introduced in 1983 and the loophole-closing legislation introduced in the House in 1984. The SIA, however, opposed the Wirth moratorium bill [43] that would have restricted combinations of securities firms and insurance companies as well as combinations of these sectors and banking, and strongly opposed the provisions of the Energy and Commerce bill [44] that would have subjected the securities industry to rules to prevent conflicts of interest similar to those that apply to banks. In arguing against expanding banks' powers, the SIA focused on the special role of banks, ignoring the unique role of their own industry and concerns that the consolidation of securities and other nonbank financial functions could significantly alter the mission of that industry and undermine the effectiveness and objectives of securities regulation.

The American Bankers Association and Association of Bank Holding Companies favored the broad range of additional cross-industry activities provided under the Treasury and Garn bills and opposed a moratorium. Both of these trade groups tend to be dominated by large banks that also oppose loophole-closing legislation. The trade association that represents small banks, the Independent Bankers Association of America, appears to favor expanded powers for banks. But the IBAA supported the moratorium legislation in 1983 because some of the movement across industries involves the use of nonbank banks which have also been used to evade restrictions on interstate banking. It supported the Treasury proposal,[45] the Garn bill [46] and the loophole-closing bills adopted by House committees [47] for the same reason.

Until recently, the insurance industry had focused most of its attention on restructuring initiatives originating in the various states that would permit banks to underwrite and sell insurance. But the introduction of the Treasury proposal galvanized this state-regulated industry to turn its attention to the Federal level as well. It was sympathetic to the moratorium legislation as an alternative to the Treasury proposal but (ironically, given its opposition to Federal preemption of state regulation of insurance) indicated that the various moratorium bills introduced in 1983 did not go far enough because they failed to preempt state initiatives that permit nonmember banks to engage in insurance activities within the state. An amendment extending the limitations of the Garn-St Germain Act to depository as well as non-depository affiliates of bank holding companies was added to the 1984 legislation adopted by the

---

[43] H.R. 5342, 98th Congress, 2nd Session.

[44] H.R. 5881, 98th Congress, 2nd Session.

[45] S. 1609 and H.R. 3537, 98th Congress, 1st Session. The Independent Bankers Association, however, favored an amendment to the Treasury proposal to prohibit bank involvement in underwriting corporate securities.

[46] S. 2181, 98th Congress, 1st Session.

[47] H.R. 5916 and H.R. 5881, 98th Congress, 2nd Session.

Senate[48] and to both the Banking Committee and Energy and Commerce bills[49] as well. The insurance industry supported all three bills.

Like the SIA, the insurance industry argued that banks are special but tended to ignore the implications of consolidating insurance and other financial and commercial activities for their role as managers of an expanding pool of investment funds. Moreover, as their support for the Senate bill implies, the insurance trade associations evidently believe that involvement in insurance is a greater threat to banks' special role and to soundness than expanding banks' securities powers.

A substantial portion of the thrift industry is suspicious of proposals for further expanding the powers of financial institutions before they have had time to digest the impact of the 1982 Garn-St Germain Act. Some fear that only a few institutions would have the opportunity to take advantage of the new powers that would be authorized under the holding company structure provided by the Treasury bill, because, traditionally, most of the industry has been mutual in form—not stockholder owned. The major thrift trade association expressed concern about a further rush into a future in which thrifts' competitors—banks—would have new powers which they could not readily match. Spokesmen for thrifts generally supported the Capital Markets Commission bill[50] because it provided wider participation in formulating proposals for legislation and better met the need for devising a regulatory structure that is parallel with new powers.

Most thrifts want to retain their mortgage-lending orientation and are primarily interested in gaining additional real estate powers. Only a few are primarily interested in undertaking securities activities other than discount brokerage and underwriting mortgage-backed securities, and many view Glass-Steagall prohibitions as an important element in preventing conflicts of interest between lenders and issuers. On the other hand, some thrifts and their regulators saw affiliations with insurance companies as providing a new source of capital for the industry and fought for provisions in the Senate bill[51] adopted in September 1984 that would facilitate these affiliations.

Another group of players who have taken an active interest in Congressional proceedings are the commercial conglomerates that own thrifts and nonbank banks. So far, Sears has acted as the major spokesman for this group, extolling competition and promoting "consumer" banks.[52] Although Sears has been active in refuting concerns that its ownership of "consumer" banks will result in conflicts of interest or the concentration of financial resources,[53] it has yet to make a case for the need for more convenience in supplying consumer credit. In the face of an increase in consumer debt in the United States to historic levels,[54] some would argue that consumer banks would be more appropriate for a country like Japan that needs

---

[48] S. 2851, 98th Congress, 2nd Session.

[49] H.R. 5916 and H.R. 5881, 98th Congress, 2nd Session.

[50] H.R. 3397, 98th Congress, 1st Session.

[51] S. 2851, 98th Congress, 2nd Session.

[52] Provisions authorizing "consumer" banks were included in the Garn bill as introduced (S. 2181, 98th Congress, 1st Session) but, as discussed above, were rejected by the Senate Banking Committee.

[53] See Part II, Chapter 3.

> . . . to revamp its economy from one so heavily dependent on exports to one where gross national product is fueled by domestic demand. . . . This means transforming a banking system that squeezes consumers to save and channels their deposits into cheap funds for export-oriented companies into one that leads to more domestic spending and investment.[55]

Clearly, the United States faces very different needs in terms of economic adjustment and requires a very different transformation of its financial system to reduce its trade deficits and restore balanced growth and international competitiveness.

While this brief outline of group positions does not take into account the dissenting views of individual institutions, it does suggest that functional regulation and the "level playing field" concepts may not be useful in developing a consensus position on restructuring for the industry as a whole. Some sectors of the industry use these concepts to advocate regulatory, not structural, change. They tend to favor a structural framework that maintains the separation of functions. But, recognizing that a significant degree of product overlap has always been present and has increased significantly, they argue that differences in regulatory treatment create competitive inequities that should be addressed by more uniform regulation. The concept of functional regulation is compatible with this view and should not be seen as a proposal embraced solely by those who favor consolidating financial functions.

There are also significant differences in views on whether or not restructuring will result in an increase in competition. Some financial institutions—particularly those that are already engaged in multiple financial services—and other interested parties have argued that resistance to restructuring comes primarily from those institutions or financial sectors that fear competition. It could as easily be argued that fear of competition may force individual institutions to undertake activities for which their resources may be inadequate. Historical precedents suggest that, as the pace of restructuring quickens, lemming-like responses may be all too frequent.

Moreover, fear of competition is not an irrational response if based on the perception of real inequities in the ability to compete. Some of the "level playing field" debate calls attention to prospective as well as existing inequities. As discussed, the inherent market power of depository institutions is an important factor in assessing how equitable the competitive environment will be after restructuring takes place. And, because banks are more numerous and the capital bases of major banks much greater than those of all but a few of the largest securities firms and insurance companies, it is more likely that most of the active acquisitors will be banks, rather than other financial intermediaries. On the other hand, if commercial firms are allowed to own banks, the outcome of restructuring could be very different since their capital bases relative to assets are much larger than those of banks.

---

[54] See Part II, Chapters 3 and 4 and Table 9, Appendix A.

[55] Jeffrey E. Garten, "Shaping a New Society: Can Japan Create a Nation of Consumers?", *The New York Times*, September 1, 1985, p. F3.

Competition from banks could also result in other changes in the structure of the financial services industry. There could be a further consolidation of securities firms to avoid unfriendly takeovers by banks or a proliferation of affiliations between securities and insurance companies and thrifts and insurance companies, who may view each other as "white knights" should an avalanche of mergers and aquisitions eventuate. In any event, the competitive environment will change radically as restructuring proceeds, and how it will fall out for different sectors or financial functions is difficult to predict. Caution on the part of individual institutions and trade associations in the face of such uncertainty is not surprising.

Given the diversity of views within the financial services industry, it also is not surprising that restructuring efforts based on equalizing competitive opportunities have ended in a stalemate. Proponents of deregulation have made little effort to elicit the views of those who use and depend on financial institutions to raise funds in capital and credit markets. Witnesses drawn from the business, labor, consumer and state and local government sectors who have appeared before the Subcommittee on Telecommunications, Consumer Protection and Finance have indicated widespread dissatisfaction with conditions in financial markets and concern about their future prospects in the light of changes now taking place.[56]

But they represent only a minority who have become actively involved. Those who benefit most from a stable and efficient system of allocating capital and credit—the business sector—have not been involved. Nevertheless, the testimony of nonfinancial witnesses makes clear that, if the financial pie is to be recut, they should not be excluded from the decision-making process. Their needs and the kinds of institutions and instruments that can best supply those needs must also be taken into account in deciding the size of shares.

SUMMARY AND CONCLUSIONS

Many of the witnesses who testified at this Subcommittee's initial hearing on financial restructuring in June, 1981 stressed the need to examine the basic rationale for laws and regulations and to proceed slowly in making changes in order to preserve fundamental regulatory objectives. One witness summed up these views as suggesting that a consensus on basic objectives was required as a framework for making change.[57]

By the spring of 1984, many believed along with Federal Reserve Board Chairman Volcker that there was "a wide area of conceptual consensus, and a critical core of legislation—on the definition of a bank and a qualified thrift and on regulatory simplification . . ."

---

[56] See Part II, Chapter 1

[57] Testimony of Stephen J. Friedman, *The Securities Industry: Economic Implications for the Future*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 97th Congress, 1st Session, June 17 and 18, 1981, Serial No. 97-34, p. 206

AVAILABLE

However, as Chairman Volcker told this Subcommittee: "The remaining issues surrounding the particular powers of a bank holding company are inevitably more controversial . . ." Nevertheless, he believed they were "ready for decision", adding: "We should not confuse lack of agreement among affected industry interests with the absence of necessary information and argumentation." [58]

In retrospect, it seems clear that the only real area of consensus in 1984 was on the need for Congressional action to close the nonbank bank loophole. On the remaining issues, lack of agreement was apparent not only among the affected industries but within the Congress, between Congress and the Administration, among the states and even among the regulators. But the underlying concern behind the pressure for Congressional action—the need to preserve options given the rapidity of developments—appears to have been justified.

Congress' options to determine the direction and pace of financial restructuring clearly have been reduced. The major decisions made in 1985 largely reflected the actions of the courts and the states. The Supreme Court affirmed the constitutionality of regional interstate banking compacts and the decision on nonbank banks in the 11th Circuit put at least a temporary halt to the exploitation of this loophole. Some regarded these decisions as an adequate response to current needs and concerns. Other would disagree, arguing that these were piece-meal responses based on interpretations of existing law; that the courts cannot provide the framework needed to address the broader issues posed by changes in financial products and functions.

As of December 1985, pressure for Congressional action had weakened. Even that core element in the consensus had fragmented. Although the House Banking Committee reported a bill closing the nonbank bank loophole [59] and another bill providing a "trigger" for nation-wide interstate banking for states that have endorsed regional compacts,[60] the Chairman and Members of the Senate Banking Committee oppose the "trigger" provision. And while Senator Garn has yet to introduce legislation, he is likely to reintroduce many of the provisions of the 1984 bill which was overwhemingly approved by the Senate. Thus the House and Senate will face the same problems in terms of reconciling differing philosophies and solutions with, perhaps, the additional problem of reconciling opposing views on interstate banking—a subject that was either ignored or not a priority issue in previous bills. In short, a greater number of players perceived some advantage in even further delaying Congressional action.

Meanwhile, there is increased concern about the fragility of the financial system and the threat it poses to the deposit insurance funds. Some believe that another crisis like Penn Square, Continental Illinois or the Ohio and Maryland thrift crises will galvanize Congress into action. But it is not clear what form of action might result. As exemplified by legislative proposals to regulate the government securities market, the response may be narrowly focused on a particular problem rather than on overall structural issues.

---

[58] *Financial Restructuring: The Road Ahead*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Congress, 2nd Session, April 4 and 5 and May 17, 1985, Serial No. 98-144, p. 94.

As discussed in Part II, Chapter 3, Chairman Volcker also agreed that the Subcommittee's concerns about conflicts of interest and concentration resulting from the consolidation of nonbank financial functions should be addressed. But he argued that resolving the issues of bank powers and loophole exploitation shouldn't wait on consideration of these other issues.

[59] H.R. 20, 99th Congress, 1st Session.

[60] H.R. 2027, 99th Congress, 1st Session.

The current effort to restructure the financial system is occurring in a very different climate from that of the 1930s when the last major decisions on financial structure were taken. Obviously, both the economy and the financial system are sounder and more stable than was the case during the Depression. That makes it more difficult for a consensus to develop around legislative solutions. But acknowledging that difficulty does not mean that Congress' role in this (or any other) area should only be reactive. In the case of financial restructuring, a reactive response—or even one that merely sanctions what has already occurred—would be irresponsible; restoring U.S. economic stability is a priority objective and stabilizing the financial system will be a critical component of that effort.

The major thrust of this Subcommittee's efforts over the last five years is reflected in the following remarks by Rep. Thomas Tauke in May 1984:

> What I think we are trying to do is assess what kind of impact the structure of these financial institutions and the structure of this regulatory scheme will have on the flow of capital to consumers and what impact does it have on the stability of our economy as a whole. That is the larger question.[61]

This report attempts to build on and extend those efforts to provide the information and argumentation needed to form a consensus on the basic objectives of financial regulation in the 1980s. Without such a consensus, a rational and coherent structural and regulatory framework will not be developed and, in its absence, our financial system will be less sound and less responsive to economic objectives than in the past. Discussions of these concerns in the Subcommittee hearings[62] form the basis for much of the discussion in Part II which examines the impact and implications of current developments and proposals for restructuring on traditional regulatory goals.

---

[61] *Financial Restructuring: The Road Ahead, op.cit.*, p. 564.

[62] Appendix C describes the issues and witnesses involved in these hearings.

BLANK PAGE

PART II: THE GOALS OF REGULATION

BLANK PAGE

INTRODUCTION

> The primary reasons for bank supervision lie in the fact that, by the very nature of their business, banks are quasi-public institutions; and in the further fact that, at times, some banks have failed to meet their obligations and responsibilities, with serious consequences to the public. Banks are the principal source of commercial credit and of the means of payment . . . through which most of the business of the country is carried on. The ability of banks to meet the credit needs of the country has a great and direct influence upon all types of business and productive enterprises and upon the prosperity of the country as a whole. Failures of banks have effects far beyond the immediate fortunes of the individual depositors or borrowers and frequently have disturbing effects beyond the reaches of the immediate territory served by the banks. The banking business, therefore, has long been regarded by the Federal Government, the States, the public generally, and the bankers themselves, as one that is properly subject to governmental supervision.[1]

When this explanation of the reasons for government supervision of the banking system was published in 1941, the role of the banking system in the economy was widely acknowledged to be that of a key industry. It still is. But many would now argue that other financial sectors play equally important roles in meeting the financial needs of the country and ensuring its prosperity; that the fiduciary nature of their business—the business of what we now call the "financial services industry"—entails quasi-public responsibilities, and that their failures, too, have widespread repercussions for the economy as a whole.

The notion that the financial system as a whole is special is not new. But given the segregation of financial functions mandated by the structural and regulatory framework devised in the 1930s, contemporary analysis of financial institutions and activities has tended to focus on individual sectors. Nevertheless, there is a unifying theme in the extensive body of law and regulation governing U.S. financial institutions: recognition of the financial system's economic role. Unless the system as a whole facilitates the process of transforming financial capital into economic activity and growth, efforts to protect customers will be meaningless. Lack of growth weakens both the economy and the value of the financial investment that backs it. Laws and regulations that require disclosure, portfolio diversification and margin requirements on credit-financed purchases of stock as well as those that prevent conflicts of interest, fraud, financial manipulation and excessive speculation, guard against diversions of financial resources into nonproductive uses. They also serve as a reminder to financial institutions that the fiduciary responsibility to make credit decisions that maintain the value of investment is a responsibility so critical to the well-being of the economy that it makes the quasi-public nature of their business indisputable.

---

[1] Robert F. Leonard, "Supervision of the Commercial Banking System", *Banking Studies*, By Members of the staff of the Board of Governors of the Federal Reserve System, Washington, 1941, p. 190.

Reflecting the primacy of the fiduciary nature of the services offered by these institutions, another central objective of regulation and supervision is to protect their customers. Whether that customer is an individual, a company, a government agency or another financial institution; a depositor, investor, policy holder, borrower, or securities issuer—each receives a substantial degree of protection.

The kinds of protection offered to customers of financial institutions vary greatly and involve very different strategies. There are, however, significant relationships among both objectives and strategies. For example, soundness regulation, intended primarily to safeguard the institution itself, is also a primary tool for protecting individual customers, communities and the nation as a whole from the disruptions and loss of income associated with financial failures. Preventing conflicts of interest and the concentration of financial resources promotes both soundness and competition. But regulatory strategies that prevent conflicts of interest and concentration—together with those that require portfolio diversification by institutions to promote soundness and competition—also ensure a greater degree of fairness, objectivity and impartiality in the allocation of capital and credit, the key objective of laws and regulations that protect customers who raise funds in financial markets.

The structure of the financial system also plays a role in influencing the performance of its economic functions. The segregated structure that has characterized the American financial system has been associated with specific "missions" for the various financial sectors. For example, securities firms and exchanges perform the function of channeling long-term financial investment into capital formation. The "mission" of the insurance industry is the assumption of risk for both individuals and companies—a role that is vital to the operation of U.S. businesses. But its financial function—like that of other institutional investors that manage pension funds, trust accounts and other pools of savings—involves the investment of huge financial resources and thus entails a major role in capital formation. The traditional role of commercial banks, on the other hand, has been to use short-term deposits to provide short- and medium-term commercial loans for working capital. Thrifts are repositories for household savings used to finance long-term, fixed-rate mortgages for housing, and credit unions use household savings for consumer lending.

These "missions" have tended to be defined and encouraged by limitations on the functions and/or portfolio strategies of the various types of institutions which serve to channel savings and credit to a given economic sector. It is argued that this structural strategy helps to ensure adequate financing for all economic sectors and thus to promote balanced growth and economic stability; that, by promoting the diversity and multiplicity of credit sources, it fosters a broader spectrum of opinion in the credit decisionmaking process. Segregating financial functions is an effective strategy for preventing conflicts of interest [2] and concentration which are also viewed as impediments to ensuring impartiality in credit decisions made by individual institutions. In addition, it is believed that encouraging specialization promotes a higher level of managerial competence in providing financial services.

The following chapters of this report will explore what appear to be the primary goals reflected in the structural and regulatory framework that has governed the U.S. financial system for the past fifty years: ensuring fair access to capital and credit, balancing competition and soundness, and preventing conflicts of interest and the concentration of financial resources. The final chapter in this section deals with issues relating to the economic performance of the financial system, focusing on changes in financial structure and regulation that have altered the function of long-term capital markets and that have important implications for capital formation and future economic growth. Another central goal of financial regulation—customer protection—is discussed in Part III.

Such an exploration—however inadequate to the scope of the issue—is intended to provide some means for assessing the continued validity of existing regulatory goals and the framework in which they are currently embodied. Because that framework is breaking down, its effectiveness in promoting these objectives also may have been weakened. If so—and if these objectives continue to offer a viable rationale for financial regulation—restructuring efforts may require a broader focus than that which has dominated the debate so far.

As the following discussion indicates, equalizing competitive opportunities among financial institutions—the primary theme in the current debate on financial restructuring—is only one of the many objectives that regulation has sought to achieve in the past. Restricting the focus to so narrow a perspective obscures these objectives and the benefits they provide.

As stressed in the previous section, this report offers few recommendations for devising a new structural and regulatory framework for the financial system. It is intended to raise questions about the adequacy of current proposals and the process of restructuring to date. Exploring the historic goals of financial regulation provides a context for making such assessments. The fact that, in some cases, it points up the extent to which regulation has failed to meet the intended standard does not mean that those standards should now be ignored.

---

[2] In a letter to the Subcommittee, June 5, 1985, Stephen J. Friedman wrote that it is true that segregating financial functions is an effective way to prevent conflicts of interest, ". . . but in fact there is no segment of the financial markets that segregates financial functions to the extent necessary to attain that result. Securities firms are money managers, brokers, dealers and underwriters. Insurance companies are insurers, money managers, lenders, broker-dealers and major investors. . . . I do not believe that segregation of function is realistic. But conflicts can be forbidden, others can be managed. They are in fact dealt with by a host of regulators on a daily basis."

BLANK PAGE

CHAPTER 1: ACCESS TO CAPITAL AND CREDIT

INTRODUCTION AND SUMMARY

The fairness of access to capital and credit has been a recurrent theme in U.S. public policy debates for more than a century. It was an issue associated with reform movements led by Andrew Jackson and William Jennings Bryan and, following the panic of 1907, was revived by the Pujo Committee and in subsequent debates on the Federal Reserve Act of 1913. In addition to inadequacies in the monetary system and the effects of the gold standard in constraining the expansion of money and credit needed by a growing economy, conflicts of interest and the concentration of financial resources in what were then termed the "money trusts" were thought to produce distortions in the allocation of credit in the early years of this century. Widespread public awareness and concern about these issues resulted in a substantial increase in government intervention in defining economic and financial structure.

While the antitrust acts were an important element in curbing concentration in non-financial sectors, various provisions were specifically incorporated in banking law—including the Federal Reserve Act and elements in the design of the Federal Reserve System—"to ensure equality of access to credit by the various geographic regions and prevent the domination of money and credit by New York." [1] The McFadden Act of 1927 which clarified the states' power to make decisions on intra-state and interstate branching by banks was intended to achieve the same objective. Meanwhile, persistent efforts were made in the 1920s to add a governor to the Federal Reserve Board to represent the agricultural sector, and the first of the Federal credit programs—establishing the Federal land banks—was enacted in recognition of the need by farmers for improved access to credit.

Over the last fifty years, initiatives to improve access to capital and credit have continued to reflect concerns about the geographical distribution of credit flows and the fairness of access for different economic sectors. They have also addressed the issue of fairness with respect to the size and status of borrowers within a given economic sector and among individuals of different income groups. Another concern has been the need to maintain a balance between the availability of short- and long-term credit in meeting different borrowing needs within all sectors and income groups.

---

[1] One of the more important structural decisions was the establishment of 12 regional reserve banks with separate reserve, discount and lending facilities. Before the creation of the Federal Reserve System, banks placed their reserves with money center banks. A substantial portion of these funds were held by New York banks and invested in call loans. Small and regional banks depended on money center banks for liquidity but were always last in line when funds were in short supply. Moreover, excessive speculation on Wall Street inevitably destabilized credit markets elsewhere. The decentralization of reserve holdings and discount facilities helped alleviate these problems to some degree. With the development of open market operations as the primary policy tool, however, the System inevitably became more centralized. (*Federal Reserve Structure and the Development of Monetary Policy—1915-1935.* Staff Report of the Subcommittee on Domestic Finance, Committee on Banking and Currency, U.S. House of Representatives, 92nd Congress, 1st Session, December 1971, pp. 11-16; 142-149.)

In this period, the structural and regulatory framework for the financial system has played an increasingly important role in promoting the fairness of access to capital and credit. Its emphasis on diversity and the segregation of financial institutions and markets has been one means of encouraging neutrality in credit decisions.[2] Some specific examples of structural and regulatory tools used to promote diversity and equitable access to capital and credit include:

Glass-Steagall restrictions separating commercial and investment banking and McFadden and Bank Holding Company restrictions on interstate banking.—These restrictions have been relied on as major tools for ensuring diverse sources of credit. Together, they have contributed to maintaining a financial system organized within concentric circles that encompass local, regional, national and international boundaries. That framework was intended to promote a better geographical distribution of credit and to meet the varied credit needs of individuals of different income groups and of business, agricultural and state and local government borrowers of different sizes and with different credit standings. The Glass-Steagall restrictions, together with other regulations discussed below and elsewhere in this chapter, were also intended to promote a balance between short- and long-term sources and uses of funds by separating markets for financial instruments of different maturities.

Restrictions on banks' investments in corporate securities and on interest payments on deposits.—These restrictions were also intended to maintain a balanced distribution between short- and long-term financial investment and borrowing. And by reducing the cost of funds to depository institutions, interest rate ceilings helped maintain—or as many would argue, subsidize—access to financial services for individuals of whatever income group and commercial or public sector borrowers of whatever size or status. As the effectiveness of interest rate restrictions were eroded in the 1970s and with the decision to phase out Regulation Q in 1980, the Community Reinvestment Act has become a more important tool for assuring broad access to financial services. However, the CRA, which applies only to depository institutions, focuses more narrowly on low-income individuals and neighborhoods. It is of less value in meeting the needs of middle-income individuals and small- and medium-size businesses that are not located in low-income communities.

Some of these and other devices discussed in this chapter were designed to encourage an impartial allocation of credit by individual institutions. Others, however, are more explicitly allocative and, together with tax policies and government credit programs, reflect concern that a completely neutral system for allocating credit may disadvantage some borrowers who may be priced out of the market. As one FINE Study analyst noted in commenting on proposals to eliminate allocative mechanisms, easing the movement of capital—

---

[2] See Part II, Chapter 3.

> . . . is desirable to the extent that, but for such "ease", capital-surplus regions would be unlikely to use the funds they have and capital-deficit regions unlikely to be able to get the funds they need. But this is undesirable to the extent that such "ease" drains funds from areas in which, for socio-political reasons, we are unwilling to see disinvestment even though such regions may not be able to compete for funds, on a price basis, with borrowers in other regions.[3]

As this statement suggests, U.S. financial structure and regulation embody two seemingly conflicting views on intervention strategies. On the one hand, they reflect the belief that *financial structure and regulation should ensure neutrality in credit flows;* on the other, that *government should intervene directly to allocate credit to specific sectors.* Both, however, have resulted in efforts to alter the effects of what were viewed as imperfect markets for credit allocation.

The debate on the merits of each of these strategies has persisted, but new strategies reflecting both approaches have been added in almost every decade in this century. As this experience suggests, however, a consensus on the need to correct market imperfections has also persisted. Moreover, a degree of compatibility has been achieved by a basic framework for financial structure and regulation that emphasizes impartiality in credit decisions made by individual institutions, with an overlay of allocative mechanisms that make use of additional structural and regulatory strategies, tax policies and government credit programs.

Nevertheless, there are inherent tensions and conflicts between mechanisms that promote neutrality and those that are specifically allocative. Because allocative mechanisms are targeted to particular sectors and regions, credit constraints may develop in other sectors or regions that are not afforded special treatment, even if credit decisions are otherwise impartial. The discussion of credit flows in the 1970s (elsewhere in this report)[4] illustrates that problem and suggests some of the policy concerns that may arise because of government intervention in allocating credit. For example, distortions in credit flows may occur because of lagged responses to changes in economic structure. If there is no periodic, comprehensive review of allocative mechanisms and a reordering of priorities, the tendency to add new allocative mechanisms to resolve new problems may result in overlapping or conflicting objectives. On the other hand, piecemeal attempts to halt or dismantle allocative mechanisms may perpetuate rather than rectify distortions.

The opening section of this chapter outlines the Federal government's role in financial markets. It provides a brief description of tax and credit programs that influence the distribution of savings and credit, and a somewhat more extensive discussion of the ways in which financial structure and regulation affect those flows.

---

[3] Roy A. Schotland, "Bank Holding Companies and Public Policy Today", Compendium of Papers Prepared for the FINE Study, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Cong., 2nd Sess., June 1976, p. 258.

[4] See Part I, Chapter 3; Part II, Chapter 4 and Appendix A.

This section is followed by a discussion of interest rate deregulation in terms of its influence on the macroeconomic environment and on the availability of bank services to lower-income individuals and communities. The subsequent section describes ways in which new financial products and services alter traditional channels for savings and credit flows and how they impact on access to credit and the balance between short- and long-term funds raised and supplied in capital and credit markets. Most of the focus here is on developments in the banking sector. Developments in securities markets are discussed in a subsequent chapter.[5]

As these sections suggest, the erosion of the old framework for financial structure and regulation has resulted in significant changes in savings and credit flows that have important economic repercussions. Perhaps the most important consequence of the current piecemeal process of financial restructuring is that it has distorted the balance between short- and long-term financial investment and borrowing.[6] The next section underscores this development, pointing out the absence of market innovations to increase the flow of long-term financial investment needed to finance capital formation.

The final section of this chapter focuses on the major policy issues that confront Congress in making choices about financial restructuring: will continued unwinding of the existing structural and regulatory framework result in a better system for allocating capital and credit? While free and perfect markets exist in theory, do they exist in fact? Given the world we live in—a world in which all governments (including our own) intervene in financial markets to implement economic policy objectives—can we assume that unregulated or less regulated markets in the United States will result in perfectly neutral credit flows? Will they make as great—or greater—contributions to economic growth as our financial markets have made in the past?

AN OVERVIEW OF THE FEDERAL GOVERNMENT'S ROLE IN FINANCIAL MARKETS

The Federal Government acts as a major influence on the way capital and credit markets distribute funds to various geographical regions and borrowing sectors. The influence exerted by fiscal and monetary policy on investment and borrowing decisions is widely acknowledged. No less important is the influence the government exerts through regulatory and structural policies, tax policies and its direct involvement in allocating capital and credit through specific Federal programs.

Regulatory and structural policies

Using the tools of regulatory policy, the Federal government undertakes to maintain the degree of public confidence necessary for an efficient payments system and to promote saving by assuring the safety and soundness of financial institutions and preventing anti-competitive, manipulative and fraudulent practices. Because the institutional structure of financial markets influences the distribution of savings and credit which, in turn, has effects on the level and composition of economic activity, regulatory policy also influences the allocative function of the markets. Some policies are designed to promote impartiality in granting credit. For example, the Community Reinvestment Act of 1977 provides that in granting applications to charter new depository institutions or for additional branches or acquisitions, Federal regulators are required to take into account an institution's actual or prospective record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods. But there are also older, more powerful mechanisms which promote impartiality through disclosure and prohibitions against conflicts of interest and concentration. As discussed, restrictions on interstate branching were also intended as a means to promote neutrality and diversity in credit flows by preventing concentration and ensuring that local banks would meet local credit needs.

---

[5] See Part II, Chapter 4.

[6] The implications of the increase in short-term financial investment for the corporate sector are also discussed in Part II, Chapter 4.

Other regulatory policies are designed to channel savings to intermediaries that specialize in lending to sectors that are thought to require preferential access to capital and credit. The most frequently discussed example of this type of regulatory policy is Regulation Q. Until recently, Regulation Q imposed interest rate ceilings on all time and savings deposits at banks and thrifts, with a higher rate for thrifts to enable them to better compete with banks in attracting funds. The purpose was to channel individual savings into mortgage lending. This regulatory policy was buttressed by a structural framework that prohibited the acceptance of commercial deposits by savings and loan associations and required that the bulk of their deposits be invested in mortgages.[7] A similar structural framework is used to channel loans to consumers at reasonable rates of interest through credit unions where the requirement of a common bond ensures that a credit-worthy shareholder will have access to credit.

The compartmentalization of financial sectors has tended to reflect the individual missions of other intermediaries as well. The mission of securities markets is capital formation. Investment bankers play the primary role in executing this mission but institutional investors—insurance companies, mutual funds, pension funds and bank trust departments—are also participants in channeling the funds of individual investors into long-term corporate debt and equity securities. Commercial banks have also been structured and regulated to serve a particular borrowing sector. As the term "commercial bank" suggests, their function is to make short- and medium-term loans to companies engaged in businesses ranging from agriculture to transportation. Some of these companies would qualify as securities issuers, but most (especially small businesses) would not.

---

[7] Many of these restrictions were removed by the Garn-St Germain Act of 1982 but there are still significant restrictions on savings and loan associations' lending powers and they remain essentially housing- and consumer-oriented institutions.

The role that financial structure plays in channeling savings determines its allocative function. Different sectors traditionally have managed investment strategies involving different risks and maturities. Securities markets and institutional investors that use those markets dealt primarily with long-term investment and borrowing strategies.[8] Because of the inherent risk that financial and economic conditions will change over time, the efficiency of long-term financial markets depends upon their liquidity. For example, the breadth and depth of secondary markets for securities provide flexibility for investors in long-term financial assets, and help minimize the risk of changes in financial or economic conditions. But well-developed secondary markets also benefit the issuer of long-term debt and equity securities by reducing the cost of floating new issues.

Institutions such as banks that fund short-term loans with short-term liabilities face different risks. Their primary concern—and that of their depositors—is immediate liquidity. Because they must be able to pay out depositors' funds within a short time-frame or on demand, the efficiency of their managerial strategy depends upon their ability to match the maturity and interest rate spread between sources and uses of funds. The degree of risk involved in matching the maturity and return on loans relative to deposits led, by way of panic and bank closures, to provisions in the 1933 Act that created the Federal Deposit Insurance Corporation (FDIC), prohibited interest payments on demand deposits and imposed interest ceilings on savings deposits. Deposit insurance reduces the risk to depositors while interest rate ceilings reduced the risk to banks. This, in turn, tended to stabilize the availability and cost of deposits and lower the cost of loans—a gain in efficiency from the perspective of borrowers.

There are still other regulatory policies which, although designed for other purposes, also affect the allocation of capital and credit. For example, the imposition of ERISA funding standards in the mid-1970s increased the rate of growth of pension fund assets and thus resulted in a higher level of saving and more long-term investment and capital formation than otherwise would have occurred.[9] But the primary examples of this type of regulation are prudential rules (including margin requirements) limiting investments and loans to individual borrowers. The National Bank Act limits extensions of credit to individual borrowers in relation to bank capital and many states have similar limitations. There are also holding limits on the investments of insurance and investment companies in the stocks or bonds of individual companies. By requiring diversification, these regulatory restrictions serve as important elements in preserving the safety and soundness of financial institutions. They also make a significant contribution to widening access to capital and credit. They are not applicable in all cases—to bank trust departments and aggregate pension funds managed by a single institution, for example—and, as discussed below,[10] the result has been sizable concentrations of lending or investment involving single borrowers.

---

[8] The recent shift to shorter-term strategies is discussed below and in Part II, Chapter 4.

[9] Benjamin M. Friedman, "Effects of Shifting Saving Patterns on Interest Rates and Economic Activity", *The Journal of Finance*, Vol. XXXVII, No. 1, March 1982, pp. 37-38; Testimony, *The Future of Financial Markets*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, July 14, 1983, Serial No., 98-42, pp. 256-257.

Some of the regulatory and structural strategies described here are summarized in Table 3. The table shows the primary institutions and borrowers affected as well as the intended objective. This is, of course, only a partial outline, covering only the more widely recognized mechanisms. A more comprehensive evaluation is needed but is beyond the scope of this report.

TABLE 3.—SOME REGULATORY AND STRUCTURAL STRATEGIES AFFECTING ACCESS TO CREDIT AND CAPITAL

Form of intervention	Specific strategy	Financial institutions affected	Borrowers affected	Access objective
Regulatory	Disclosure	Investment banks	Corporate business	Impartiality
Do	Lending and investment limits	Depository institutions insurance companies, mutual funds	All sectors	Do
Do	Margin requirements	Banks, securities firms	Individual investors, speculators	Do
Do	Anticoncentration mechanisms	Insurance companies, depository institutions	All sectors	Do
Do	Restrictions on transactions with affiliates	do	do	Do
Do	Community Reinvestment Act	Depository institutions	do	Do
Do	Regulation Q [1] (interest rate ceilings)	do	Home buyers, housing industry and small borrowers in other sectors	Allocative
Structural	Thrift system	Savings and loans, mutual savings banks	Home buyers, housing industry	Do
Do	Credit union system	Credit unions	Consumers	Do
Do	Limits on institutional affiliation	Depository institutions, life insurance companies	All sectors	Impartiality
Do	Restrictions on types of investments	Depository institutions, insurance companies	Homebuyers, housing industry, commercial, state and local borrowers	Allocative (short- versus long-term investment)
Do	Restrictions on interstate branching	Depository institutions	All sectors	Impartiality

[1] Regulation Q has been phased out

It should be noted that, because of the erosion of product and structural restraints resulting from the exploitation of loopholes in current law, the effectiveness of many of these strategies has been undermined. Nevertheless, they do indicate the extent of concern for access to capital and credit embodied in current law, and suggest the need to evaluate losses and gains that will result from current or proposed changes in financial structure and regulation.

Tax policies

In addition to regulatory policies, Federal tax policies also influence the supply and demand for capital and credit and the way intermediaries meet these demands. The tax treatment of various financial intermediaries affects their competitiveness.[11] The tax treatment of certain forms of savings—insurance policies, pension fund contributions, Individual Retirement Accounts (IRAs) and Keogh Accounts, for example—or of certain financial instruments, such as bonds issued by states and municipalities and the Farm Credit System, provides potent incentives to save through these as opposed to alternative channels.[12] Similarly, the holding period applicable for capital gains, which was changed from 12 to six months in June 1984, affects investor demand for all types of equities. On the other hand, the treatment of interest payments in the tax code and provisions for tax credits for qualified business investment affect demand for capital and credit.[13] Like regulatory policies, tax policies can influence not only the level of savings and the demand for credit but how and to whom savings and credit are channeled—decisions that, again, ultimately affect the level and composition of economic activity.

---

[10] See Part II, Chapter 3.

Government credit programs

The Federal Government also has been continuously and extensively involved as an intermediary in financial markets since the 1920s. Many of the activities initiated by the Reconstruction Finance Corporation (RFC) during the 1930s, were perpetuated after its break-up in independent agencies such as the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (Ginnie Mae)[14] and the Small Business Administration.[15] The Farm Credit System[16] which predated the

---

[11] The tax treatment for depository institutions is more favorable than for other financial institutions and is an important item on the agenda of those who favor equalizing competitive advantages.

[12] Individuals with IRA or Keogh accounts or with a vested interest in their pension plan also have the ability to borrow against this money, which can then serve them in two ways—as an instrument for saving and as collateralization for new loans. Furthermore, the interest paid on a loan collateralized by retirement plan money is tax deductible; the equity in the plan is not currently taxed.

[13] For example, the fact that dividends are an after-tax cost while interest payments are tax deductible is seen by many as an incentive to businesses to issue more debt than equity and one that may discourage small- and medium-sized businesses from raising equity capital needed for expansion.

[14] Fannie Mae issues securities collateralized by mortgages that it buys from other lenders. Thus, it assists the secondary market for home mortgages by supplying a degree of liquidity for mortgage investments which then improves the distribution of investment capital available for home mortgage financing. Ginnie Mae guarantees securities backed by pools of mortgages, which are issued by Fannie Mae and others. (See Budget of the United States Government, FY 1986, Appendix, Executive Office of the President and Office of Management and Budget, p. V-13.)

[15] The Small Business Administration assists and protects the interests of small businesses by ensuring that they receive a fair portion of Government contracts, and providing Federal guarantees for loans to them and their investment companies at preferred rates. (U.S. Government Manual 1984/1985, Office of the Federal Register, National Archives and Records Services, and General Services Administration, revised May 1, 1984, p. 611.)

[16] The Farm Credit Administration supervises 12 credit banks which finance the operations of farmers' cooperatives and which discount agricultural and livestock paper for, and make loans to local financing institutions (i.e., production credit associations, agricultural credit corporations, livestock loan companies, commercial banks). Federal land banks, which make long-term real estate loans to farmers and ranchers, are also under the supervision of the Farm Credit Administration. These banks are cooperatively owned by their borrowers and their loans are not Federally guaranteed. Nevertheless, there has been a long-standing perception on the part of investors (primarily pension funds and bank trust departments) that hold some $60 billion of bonds issued by the Farm Credit System that there is an implicit Federal guarantee. Moreover, these bonds are exempt from state and local taxes. (*Ibid.*, U.S. Government Manual 1984/1985, p. 489.)

RFC has also been preserved with some changes as have other Federal credit programs enacted in the 1930s such as the Export-Import Bank and the program of loan guarantees for shipbuilding under the Maritime Acts. Since that time, new programs have been added to extend credit assistance to new borrowers—the Student Loan Marketing Association (Sallie Mae)[17] and the Veterans Administration (VA)[18] for example—or to expand or restructure assistance to existing beneficiaries.

Currently there are more than 350 government credit programs—more than 200 that provide direct Federal loans and over 150 that provide Federal guarantees or insurance for loans made by the private sector. Total outstanding Federal and federally assisted loans were in excess of $700 billion in 1982[19] and have continued to grow at a very rapid rate.

These programs, together with Federal tax and regulatory policies, demonstrate the pervasiveness of the Federal Government's role in financial markets—a role supplemented to a significant extent by similar programs and policies at the state and local government level. They obviously place a considerable constraint on the potential for permitting market forces to determine credit allocation. But they do not necessarily conflict with regulatory goals that are intended to ensure that individual institutions make impartial credit decisions. On the other hand, there may well be significant conflicts between the various Federal policies and credit programs and some validity to arguments that they focus on outdated priorities.[20]

THE EFFECTS OF INTEREST RATE DEREGULATION ON CREDIT FLOWS

The most visible and far-reaching change in the structure and regulation of U.S. financial markets that has occurred in recent years is the Congressional decision to phase-out Regulation Q restrictions on interest rate ceilings on deposits. This decision has had a dramatic impact on both the U.S. financial system and the economy as discussed below and elsewhere in this report.[21]

---

[17] Sallie Mae was created to expand funds available for student loans by providing liquidity to lenders engaged in the guaranteed student loan program. "Sallie Mae provides liquidity through direct purchase of insured student loans from eligible lenders and through warehousing advances, which are loans to lenders secured by insured student loans or the Government or agency securities." (Budget of the U.S. Government, *Op. cit.*, p. V-3.) In addition, Sallie Mae is authorized to make loans directly to students and to advance funds to States which will provide loans to students in capital deficit areas.

[18] The Veterans Administration (VA) assists veterans and servicepersons in obtaining loan guarantees for housing and education and training. Private capital is provided on more liberal terms than generally available to nonveterans. The VA also finances educational assistance allowances for eligible dependents of certain veterans. The VA Education Loan Program has experienced excessively high default rates and the Administration announced that legislation would be requested in the fall of 1985 to repeal this authority. (*Ibid.*, p. I-X24.) Many other services are also provided by the Veterans Administration, which are not, however, relevant to the discussion of access to capital and credit.

[19] Virginia A. McMurtry, *Improving Federal Debt Collection Practices*, Congressional Research Service Review, vol. 3, December 1982, p. 10.

[20] See Part I, Chapter 3, and Appendix A for a discussion of the influence of the Federal government's policies and programs on savings and credit flows in the 1970s.

[21] This section focuses on ways in which interest rate deregulation affects individuals. A subsequent chapter (Part II, Chapter 4) discusses the impact of interest rate deregulation on the business sector.

Macroeconomic effects

In a free market environment, funds tend to flow to the highest bidder. The imposition of interest rate ceilings on deposits in the 1930s was designed to alter those conditions on the grounds that the highest bidder would not always be the most desirable borrower from the standpoint of social or (even) economic objectives.

It is frequently noted that small savers subsidized borrowers under the regime of interest rate regulation. But many of these borrowers were also the household sector: individuals with the same general characteristics as small savers who used low cost funds to purchase houses, automobiles and other consumer durables. With interest rate deregulation, households now receive a higher rate on their savings but necessarily pay a higher cost for credit.

Whether or not households are better off as a result of interest rate deregulation is difficult to ascertain. If, as appears to be the case, they cannot afford long-term fixed rate mortgage credit at current rates, they may not be as well off as before. If, however, they defer purchases of cars and other consumer durables and save more, they may not be worse off by deferring consumption. But as their savings increase, consumer purchases will fall, reducing economic activity and employment in some producing sectors. A higher level of savings will not necessarily increase capital formation in these industries because, unless offset by a rise in exports, a fall in domestic demand will discourage expansion and modernization and reduce the issuance of long-term corporate debt and equity instruments. In that case, more savings would be available to finance the government's budget deficit or for foreign investment. The macroeconomic outcome would likely benefit some households because it would result in a lower rate of inflation and lower interest rates. But it may also retard future growth and the rate of increase in new jobs and income.

If, on the other hand, government deficits are reduced, a higher saving rate may contribute to an increase in capital formation and expand production in sectors not involved in producing consumer durables for domestic consumption. As is the case in many economies with saving rates higher than that of the United States, export sectors are likely to gain from a decline in consumption and may contribute to a higher level of economic growth. Under this scenario, households—and the economy as a whole—would benefit from interest rate deregulation if it has the effect of increasing savings and investment in long-term corporate securities. But if a higher level of savings does not increase capital formation in export industries and other productive sectors and does not lead to expansion in the domestic economy because savings are channeled abroad, again, the result will be a lower level of economic growth in the U.S., less employment and a lower standard of living.

It may be useful to note that while corporations, institutional investors and more affluent or sophisticated investors were able to obtain market rates of interest on short-term investments and even cash balances throughout the previous decade, the primary borrowers in this group—corporations—did not enjoy greater access to, or better terms of credit.[22] To some extent this was the result of a two-tiered market, only half of which was regulated. The other markets—the U.S. and Eurodollar money markets—were essentially free markets in which funds did flow to the highest bidders. However, foreign governments and corporations and the largest U.S. corporations tended to be the highest bidders for funds in these markets. For example, *total* U.S. bank lending to the U.S. corporate sector rose by $100 billion in the period 1977-1980, but lending by the *largest* U.S. banks to foreign governments and corporations rose by $61 billion over the same period.[23]

The inability of some developing countries to meet loan repayments has caused a drop in foreign lending that has contributed to a reallocation of credit flows. While the allocative impact of changes in international capital flows and of interest rate deregulation on private borrowers has been overwhelmed by the Federal Government's credit needs, foreign inflows and interest rate deregulation have helped meet those needs. Most of the massive inflow into the new money market deposit accounts (MMDAs) at banks and thrifts in 1983 was invested in government securities.[24] Subsequently, however, there was a rapid expansion of private debt, including a substantial increase in consumer borrowing.[25]

Moreover, while interest rate deregulation halted the devastation of the thrift industry by money market mutual funds, it has not restored thrifts' mission in promoting housing nor clarified what their role in credit markets will or should be. If the current focus on liberalizing opportunities for institutions to gather funds persists without equal concern for how funds are to be employed by the various intermediaries and markets, pressure for government to assume a larger role in direct credit allocation may grow. The fact that the role of Federal and federally sponsored agencies and pools in making mortgage funds available to homeowners is now far greater than in the past [26] could be seen as one indication of a trend in this direction.

Institutional effects: Bank service charges and branch closings

Proponents of the Depository Institutions Deregulation and Monetary Control Act of 1980 anticipated that the small saver would benefit greatly from the new products and services banks could offer. Small savers would share in the higher interest rate privileges enjoyed by large investors through such innovations as negotiated order of withdrawal (NOW) accounts. While the consumer, in general, has enjoyed some of the expected benefits, he or she has also encountered some negative effects. For the average customer, banks' fees steadily increased as their services declined. Moreover, the quantity and location of branch closings followed a distinct pattern: small, poor communities lost access to banking services. Meanwhile, there was an expansion of financial services targeted for the upper-income consumer. As a representative from the Consumer Federation of America testified:

---

[22] See Appendix A.

[23] These figures are derived from Federal Reserve Board *Flow of Funds Outstandings* and the *Country Exposure Lending Survey*. The latter source does not provide information on foreign borrowing by sectors before this period.

There was a significant increase in bank lending to U.S. corporations in 1981 but, as a recent study by the Consumer Federation of America pointed out, much of this lending was used to finance mergers (see testimony of Stephen Brobeck, *The Nation's Economy in a Changing Financial Environment, op. cit.*, July 14, 1983, p. 231). More recent evidence of the effect of mergers on capital flows and capital formation is discussed in Part II, Chapter 4.

[24] See Federal Reserve Board *Flow of Funds Accounts*. It should be noted that, despite the large inflow of funds into MMDAs, the personal saving rate in the first quarter of 1983 declined to its lowest level since 1950 as consumers used income for consumption rather than saving (with, however, positive effects for economic growth). The fact that intermediaries used savings to lend to the Federal Government rather than to consumers may have contributed to the drop in the saving rate, suggesting that there may also be an important link between credit and saving—that access to credit may influence the propensity to save.

[25] See Part II, Chapter 4.

[26] Both the value of mortgages in the portfolios of these agencies and their activity in secondary markets has risen dramatically in recent years as discussed in Part II, Chapter 4.

> Most apparent is that there are and will be distinct categories of winners and losers in the deregulation process. Among those on the losers side are small businesses and homebuyers (for whom long-term fixed rate funds are getting increasingly scarce), consumer borrowers (for whom interest rates on loans tripled in 1981 and have stayed at that level), and small depositors (for whom bank fees and service charges are on the rise). The winners are large depositors (who get a higher rate on their savings while escaping many bank fee increases), purchasers of stock (who have benefited by bank entry into discount brokerage), and those with a large portfolio of assets (who will have the convenience of doing most of their business under one roof). In the name of convenience and to the benefit of the more affluent, banking deregulation, thus far, has shifted costs onto lower middle-income consumers.[27]

As an example of this shift, another consumer advocate noted that American Express, Inc. views credit as a "privilege"—not a service that is either available and affordable for every American—contrary to long-standing U.S. tradition.[28]

Although the NOW account had been touted as one of the more beneficial of the new instruments for the small depositor, the Massachusetts Urban Reinvestment Advisory Group noted that:

> . . . a depositor could earn $2 a month on his $500 NOW account. Subtract a monthly service fee of between $2 and $5, then subtract the cost of checks and other "new" fees, and the small depositor gets a net loss from this wonderful, new, consumer-oriented product. The alternative is to take money out of the bank and lose the security of deposit insurance.[29]

In return for earning more on his saving account, the consumer necessarily incurred more costs in borrowing from his bank. Interest rate deregulation and increased competition for deposits made banks more aware of the need for earnings and for obtaining high interest yields on loans and investments. Because small deposits and small loans incur higher operating costs per dollar of interest income, banks impose extra charges on such accounts or discourage them. Banks seek to attract affluent customers with large accounts that are more profitable. There is preferential treatment for these high income, high balance accounts as well as access to new products and new and more convenient services. That narrow portion of the public is well served by banks.

---

[27] Glenn Nishimura, *Financial Restructuring: The Road Ahead*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, April 5, 1984, Serial No., 98-144, p. 479.

[28] Statement of Gale Cincotta, Executive Director, National Training and Information Center, *Ibid.*, p. 416.

[29] Testimony of Hugh MacCormack, Chairman, Massachusetts Urban Reinvestment Advisory Group, Inc., on The Financial Institutions Equity Act of 1984 (H.R. 5734), prepared for the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, June 15, 1984, p. 4.

Bankers are aware of these complaints. Their response is that deregulation so far has been applied only to the liability side of the balance sheet. What is needed is deregulation on the asset side—i.e., expanded powers. As Mark Olson, representing the American Bankers Association, argued before the Telecommunications, Consumer Protection and Finance Subcommittee:

> In addition to the increased convenience of being able to conduct various types of financial business in one location, the services themselves may be less expensive. The increased competition resulting . . . will tend to push prices down and provide consumers with more alternatives and better service. Financial institutions may also be able to produce these services at a lower cost because they can spread fixed overhead across a larger number of activities. Competition will ensure that these cost savings are passed along to the consumer.[30]

However, as a witness at a House Banking Committee hearing pointed out, "No one seems to be particularly concerned about the lower income/low balance accounts except as far as they provide opportunities for fee income and fee revenue." [31] With competition for deposits rising, banks became more interested in attracting out-of-town deposits, and in making large, more profitable loans outside their own communities. A Philadelphia banking report claimed: "The deregulation of the banking industry, and the continued flight of capital to the suburbs, the sun-belt, and abroad will continue to have a negative impact on our communities." [32] Many view the effects of deregulation on lending activities as a trend that shifts credit decisions away from the communities that banks serve to boardrooms hundreds of miles away. They argue that interstate and "upscale" banking are not beneficial to poor or rural areas. Banks must be induced or encouraged to remain in—and remain responsive to—these areas.[33]

Deregulation of the banking industry has prompted institutions of all sizes to focus on the prospects for, and consequences of, interstate and regional banking. Most agree that interstate banking in some form will eventually prevail. The money center banks are beginning to show a renewed willingness to abide by the Community Reinvestment Act (CRA) in return for the approval to merge interstate. However, this may encourage the trend toward "competition in laxity", as some states are already vying to attract new institutions by relaxing CRA enforcement. Moreover, all of the nonbank bank applications filed with the Comptroller of the Currency in 1984 and 1985 by bank holding companies to avoid restrictions on interstate banking, were for offices that would be located in upscale residential communities or commercially developed sections of cities, and eighty percent were for offices that would accept demand deposits and not make commercial loans.[34] These developments add to concerns about increased redlining, the rising outflow of capital to more profitable regions, and the decline in lending to small businesses.

---

[30] Mark W. Olson, *Financial Restructuring: The Road Ahead, op. cit.*, April 5, 1984, pp. 317-318.

[31] Statement of Dr. Nicholas M. DiJow, *How the Financial System Can Best be Shaped to Meet the Needs of the American People.* Hearings before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 98th Congress, 2nd Session, April 12, 1984, Serial No. 98-83, p. 173.

[32] Community Resource Center, *Banking Report—A Record of Community Disinvestment,* Philadelphia, PA, 1984, p. 1.

[33] Statement of the Honorable Byron L. Dorgan, *How the Financial System Can Best be Shaped to Meet the Needs of the American People, op. cit.*, p. 151.

In an attempt to counter this image, such banks as Union Planters National Bank (Memphis, Tennessee), Security Pacific National Bank (Los Angeles, California), and Wilmington Trust Co. (Wilmington, Delaware), "are introducing 'no frills' checking—low-cost checking accounts for consumers with limited banking needs who don't want to pay today's rising bank fees." [35] There are also examples of depository institutions' sensitivity to bank branch closings and their impact on communities. In response to opposition from neighborhood organizations, both the Fleet National Bank and the Old Stone Bank delayed the closing of two Providence, Rhode Island branches to "give the groups six months to cushion the blow." [36]

These developments result from passage of the Depository Institutions Deregulation and Monetary Control Act which was, in turn, a response to more than a decade of rising inflation. The effect was an abrupt unleashing of competition in areas of an industry that were previously tightly regulated. Banks and thrifts, no longer tied to fixed interest rates, suddenly found themselves in positions of greater responsibility for their profitability. Without the certainty of a steady supply of cheap deposits, depository institutions could no longer continue loaning to less-secure clients—small businesses, new firms, or questionably successful corporations. In addition, as they looked to maximize their efficiency, large institutions closed their less-profitable branches and those small institutions which were unable to compete effectively, closed altogether. While these decisions were not directed toward or against any public policy objectives, they nonetheless seriously impacted on the availability and impartiality of access to capital and credit.

The existence of a full-service bank branch in a neighborhood fulfills two purposes: it helps to meet the credit needs of the area as required by the Community Reinvestment Act (CRA) of 1977 and it acts as a sign that the neighborhood is an established and secure place to conduct business. CRA is an attempt to ensure that the public interest is served in return for the public benefits bestowed by granting a charter or approval for deposit insurance. It recognizes that meeting community credit needs is critical to the stability of neighborhoods.

---

[34] But many would buy commercial paper issued by large financial and nonfinancial corporations.

[35] Daniel Hertzberg, "Banks Are Offering No-Frills Checking To Let Customers Escape Increasing Fees", *Wall Street Journal*, August 1, 1984, p. 4.

[36] Peter Kerr, "Bank Branch Closings Jolt Communities", *The New York Times*, July 15, 1985, pp. D1 & 9.

Closing a bank branch has a number of negative effects. It usually means a reduction in the bank's lending in the affected community. When Philadelphia National Bank closed its Oak Lane branch office in 1980, its mortgage lending in that neighborhood decreased by 62 percent, while its area-wide lending increased by 40 percent. Economic development efforts are also hampered by a neighborhood branch closing. Not only do small businesses receive fewer loans, they receive less business. And new ones are unlikely to consider locating there. The result is a loss of jobs in the community. A third negative effect is the impact of branch closings on the elderly and low-income customers who have to travel greater distances to meet their banking needs.[37]

Unfortunately, branch closings are becoming a national trend. In the last decade, Philadelphia banks have closed 49 branch offices in the City, while additional branch offices have been opened in the suburbs. After steadily increasing in the late 1970s, the number of bank branch offices nationwide dropped by 1003 in 1982, according to reports from the Federal Deposit Insurance Corporation. In August, 1983, Bank of America and Wells Fargo Bank announced plans to close more than 60 of their California branches by the end of the year. In December, 1983, Bank of America made public its plans to close an additional 120 of its California branches by year-end 1984, resulting in the loss of about 4000 jobs. Management explained that the closings were part of its effort to reduce costs and streamline operations. To accommodate less affluent customers, banks proposed to supplant the closed branches with automated teller machines (ATMs).[38]

In addition to closing branches, banks have taken other actions intended to increase profitability. Banks nationwide raised fees they charged customers for services. Dr. Nicholas M. Didow summarized his research into service charges in testimony before the House Banking Committee: service charges for the average customer increased 28 percent from 1981 to 1982 and 31 percent from 1982 to 1983.[39] A *Newsweek* reporter commented that: "Banks have been slowly raising charges to shore up profits in the face of troubled loans to Third World and other debtors and to meet the new costs and competition associated with financial deregulation."[40] Rising costs are understood by customers when the quality of services also rises. However, that has not been the case. Therefore, even though other factors such as the higher cost of money contribute to rising costs, if customers feel they are getting less and paying more, they become dissatisfied.

---

[37] Community Resource Center, *Banking Report*, *op. cit.*, p. 13.

[38] The number of ATMs has quadrupled since 1980 and 1,332 access cards are lost or stolen each day. Liability for missing funds is often hotly disputed by banks and their depositors. Federal regulations limit a customer's liability depending on how promptly a lost or stolen card is reported. However regulators are finding that some banks haven't been following the rules: executives at many banks either misunderstand or ignore the rules; some banks wrongly hold customers liable for the funds, and others distribute false information about the regulations to ATM customers. In addition to increased customer liability (whether legal or not) for unauthorized withdrawals, some would argue that a greater reliance on ATMs also poses a long-term threat to privacy. (Kathleen A. Hughes, "Customer Liability is Thorny Issue in Unapproved ATM Withdrawals", *Wall Street Journal*, August 21, 1985, p. 27).

[39] *How the Financial System Can Best Be Shaped to Meet the Needs of the American People*, *op. cit.*, p. 178.

[40] Susan Dentzer, "A 'Blizzard' of Bank Charges", *Newsweek*, May 7, 1984, p. 79.

Rising fees are also more acceptable when they can be justified. Philadelphia's Mellon Bank East imposes a $30 charge for every bounced check. Many other banks charge $15 to $20. Amalgamated Bank of New York, which is owned by a clothing workers' union, charges only $4. In 1982 New York State asked banks to submit data on the actual cost of processing a bounced check. As Michael Lesser, a state banking official, reported, the banks could only justify $5 to $6 an item. The state then set a maximum fee of $7.

In response to fundamental differences in the way banks treat the public, some New York State legislators advocated "lifeline" banking services such as deposit accounts for low-income customers and the cashing of welfare and social security checks at no cost. State Senator Leichter of Manhattan conducted a survey which showed that, "the trend of making the customer of more modest means pay for foreign loan losses and higher interest paid on the accounts of the affluent is continuing." [41]

As a result of higher fees, substantial requirements for opening new accounts, and branch closings, neighborhood check cashiers are beginning to replace local banks. In New York alone, 325 check cashing "stores" can be found. They can not take deposits or offer loans, but they do offer a range of other financial services: selling money orders and lottery tickets, acting as paymasters for local businesses, serving as a conduit for paying utility bills, distributing welfare checks and food stamps, and renting mail boxes.[42] As people increasingly rely on these stores, there is an obvious increase in holdings of cash and a decline in deposit-taking and loan-making. Since higher levels of financial intermediation are associated with increases in economic activity, limits on access to banking services reduce economic growth in affected areas.

Changes in the way banks treat customers pose major problems in areas where people do not have the choice of using an alternative bank or even the choice of using a check cashing "store" if they find they can no longer afford a bank. Fairness requires that low- and moderate- as well as high-income customers have access to financial institutions and the capital and credit they provide. However, the availability and affordability of credit, as it existed before the Depository Institutions Deregulation and Monetary Control Act of 1980, could not be duplicated after such monumental changes. No longer able to attract funds at consistently low rates, depository institutions necessarily elevated "efficiency" to a much higher level. Maintaining a large number of branches and obtaining deposits mostly from individuals was no longer efficient. Requirements for efficiencies in a more competitive marketplace began to supplant traditional public policy goals. Should policy-makers decide that equality of access to capital and credit should remain a goal of public policy, new mechanisms will need to be developed to achieve this goal.

---

[41] Philip T. Sudo, "Study Assailing Bank Fees May Aid 'Lifeline' Drive", *American Banker*, July 19, 1984, p. 3.

A *Wall Street Journal* reporter offered the following analogy to illustrate the contrasting ways in which different classes of society are treated by their bankers:

> For the rich that means Rolls-Royce banking, with personal attention, interest paid on checking accounts and free checking services. For the middle-class it means Chevrolet banking, with sizable fees, sometimes long lines for personal service, and higher required deposit balances. And for the poor it means, at best, used-car banking, with very little personal service, no interest paid on checking, fewer bank branches, and fees on just about everything the bank provides.

(Daniel Hertzberg, "Smaller Customers Get Less Service at Banks and Pay More Charges", *Wall Street Journal*, October 18, 1984, p. 1.)

[42] Daniel Hertzberg, "City Storefronts Serve as Banks for the Poor", *Wall Street Journal*, January 17, 1984.

SOME PRODUCT AND STRUCTURAL CHANGES THAT ALTER FINANCIAL FLOWS

The financial system's efforts to adapt to inflation and evade or exploit interest rate restrictions resulted in several important developments that have affected financial structure and savings and credit flows. To some extent, these developments were interactive. Money brokerage developed in the 1970s as banks increased their reliance on nonregulated (and non-local) sources of funds and the interbank market to compete with money market mutual funds (MMMFs). But money brokerage became even more important as a result of the authorization in 1982 of money market deposit accounts (MMDAs), a response to the growth of MMMFs which, in turn, created the impetus for the exploitation of the nonbank bank loophole. As interest rates became more volatile and increased the volatility of markets for a broad range of financial assets, institutions created other new products such as financial futures and stock index products as mechanisms to adjust to these conditions.[43]

This section describes some of the product and institutional innovations that were used to adapt to changes in the financial environment and suggests ways in which they have altered access to capital and credit. The focus here is primarily on innovations affecting depository institutions and their products because—while differing in several important respects—these changes have one important characteristic in common: they have altered differences in risk and return between short- and long-term financial assets. For some years prior to 1970, all insured financial assets (deposits) were subject to interest rate regulation and the interest return on these assets was almost always below rates paid on noninsured assets. Investors desiring higher rates of return found those returns primarily in markets for long-term financial assets and accepted greater risk. Interest rate regulation for insured deposits created a clear distinction between long- and short-term financial assets and markets.

The first step toward interest rate deregulation was taken in 1970 when banks were allowed to pay market rates of interest on large negotiable certificates of deposit (CDs), some portion of which were insured. This was an important step in eroding inducements for investors to buy corporate stocks and bonds and its impact on securities firms and mutual funds had a significant influence on the development of competing products (MMMFs) by these intermediaries.

---

[43] The influence of new securities products on financial flows is discussed in Part II, Chapter 4.

The interaction between inflation and the competition for short-term investment funds between banks and securities firms in the 1970s forced an end to interest rate regulation and, with it, undermined an important incentive for long-term financial investment. Because interest rate deregulation permits institutions to pay market rates of interest on short-term *insured* financial assets, there is less incentive to accept the risk associated with investment in long-term instruments even at somewhat higher rates of return.

Brokered deposits

Money brokers have played an increasingly important role in channeling funds among depository institutions throughout the 1970s. They were particularly active in 1974, gathering so-called Federal funds from small banks to lend to money center banks. Even as smaller banks and thrifts lost deposits when market rates rose above interest rate ceilings, they themselves engaged in a form of disintermediation on the lending side. Some banks loaned as much (perhaps more) than a quarter of their deposits in the overnight money markets to larger banks. Federal funds and large negotiable CDs paid market rates of interest and the cost of channeling millions of dollars to a handful of major institutions was much lower than the cost of processing numerous small business loans, car loans, consumer loans, etc. to local borrowers. The practice was so widespread in up-state New York that it was referred to by local businessmen as "strip-mining" of funds.

But money brokerage has grown even more important since the restrictions on interest payments began to fall. Faced with the rising cost of attracting funds, depository institutions are even more tempted than in 1974 to place large chunks of money in the interbank market to save on the operating costs of processing small, local loans and earn what appear to be risk-free, high rates of interest.

On the other hand, the authorization of money market deposit accounts (MMDAs)—insured accounts in relatively small denominations that pay market rates of interest—has encouraged money brokers and money market mutual funds (MMMFs) to place funds across a wider spectrum of banks in terms of size and location. Even small local banks now have access to the money markets. This is an important development that has helped move funds from capital surplus to capital deficit regions within the United States (as opposed to overseas) and one that could benefit small and regional businesses, real estate developers and home buyers, municipalities and smaller, less affluent individual borrowers.[44]

Nevertheless, the risk avoidance factor in brokered deposits is one that can—and has—led to abuse. Shortly after the authorization of MMDAs, a *Wall Street Journal* article described the mechanisms for risk avoidance:

> A leader in exploiting federal insurance is Harvey Baskin & Co. of Washington, D.C. It operates CDx, or "certificates of deposit exchange", which divides deposits above

---

[44] However, the ways in which the creation of MMDAs may limit benefits to these borrowers are noted in the discussion of MMDAs below.

> the Federal insurance limit into $100,000 pieces and farms them out to the highest bidder.[45]

CDx placed between $10 million and $25 million a day without carefully scrutinizing the participating banks because "the Federal insurance is what is important." [46] Some analysts estimated that brokers nationwide were placing $12 billion annually in banks and savings and loans and that banks and thrifts held $46 billion of brokered deposits at year-end 1983.[47] But not all were as careful as CDx to protect the depository institutions that provided funds by breaking them up into insured lots. The House Congressional Credit Union had a $1 million placement with Penn Square when it failed, only $100,000 of which was insured. But this was less than one percent of Penn Square's $120 million of brokered deposits.[48]

The FDIC and FSLIC believe that heavy use of brokered deposits by weak institutions threatens the deposit insurance funds. FDIC data on closed banks in 1984 show that 25 failed banks (about a third of the total closed) had brokered deposits amounting to more than five percent of their total liabilities, that brokered deposits in 13 failed banks were in excess of 15 percent of total liabilities, and were in excess of 50 percent in four closed banks. A recent study by the Federal Reserve Bank of New York found that:

> . . . heavy use of brokered deposits is statistically correlated with relatively weaker financial performance [and that] failed banks that obtain over 5 to 10 percent of their funds through brokers tend to cost the FDIC more than other failed banks.[49]

Those who favor financial deregulation advocate greater reliance on market forces in allocating credit. But market forces, not regulation, were already in the driver's seat as funds poured into Penn Square and unleashed a flood of lending to the energy sector. The attraction was a higher return on deposits which Penn Square led others to believe it could afford because of a higher expected return on energy loans. Penn Square failed when these expectations turned sour and it was caught with too large a concentration of loans to energy companies.

But it had also used a rising level of brokered deposits to originate loans which were sold to other banks. Two larger institutions (Continental Illinois and Chase Manhattan) suffered serious losses on loans purchased from Penn Square, while a third (Seafirst) had to be merged with an even larger institution (Bank of America) to prevent its failure. Unrealistic price expectations were clearly a major factor in precipitating these losses. But overlending was also a factor—one which may have significantly reduced the likelihood of recoveries and which could not have occurred had Penn Square been unable to attract such a large volume of brokered deposits.

---

[45] "Powerful Money Brokers Threaten Some Banks' Stability, Critics Say," *The Wall Street Journal*, August 10, 1983, p. 27.

[46] *Ibid.*, p. 27.

[47] Ronald Brownstein, "Bank Insurers, Treasury Split Over Curbing Money Brokers", *National Journal*, January 21, 1984, p. 127.

[48] "Powerful Money Brokers Threaten . . . ," *op. cit.*, p. 27. This article discusses other examples of sizable brokered deposits in failed institutions, including $10 million in Western National Bank of Lovell, Wyoming attracted by a rate 2 percent higher than the going rate for other banks, and $82.2 million (about 30 percent of its total deposits) in American City Bank in Los Angeles when it failed in February, 1983.

[49] Sherrill Shaffer and Catherine Piche, *Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications*, Research Paper No. 8405, Banking Studies Department, Federal Reserve Bank of New York, November 1984, pp. 1-2.

However, brokers "maintain that most brokered funds are large institutional deposits beyond the insurance limit, and that the vast majority of insured brokered funds are long-term deposits placed in sound institutions." Merrill Lynch claims "that where institutions have failed in part because of brokered funds, those deposits have been short-term." (Anita Bedelis, "Brokered Deposits Legislation: Slow Going", *Insight*, August 5, 1985, Volume 7, No. 16, p. 4.)

Proponents of financial deregulation also advocate greater reliance on market forces to maintain sound practices. The assumption is that large depositors will refuse to put funds in poorly-run institutions. But some money brokers are undermining their arguments for permitting market forces to play a larger role in banking regulation by relying on deposit insurance to eliminate the need for concern about the condition of individual institutions. As discussed elsewhere in this report,[50] it has been suggested that deregulation may require changes in the deposit insurance program to increase the risk to depositors and raise the level of "free market" inquiry. Other proposals to prohibit the exploitation of insurance guarantees by money brokers have also been offered.[51]

Interest payments on insured transactions accounts

As a result of the 1980 legislation authorizing negotiable orders of withdrawal (NOW) accounts nationwide for consumers, individuals now may receive interest on insured transactions accounts offered by all depository institutions. Subsequently, legislation was introduced to carry interest rate deregulation to its logical conclusion by permitting interest payments on demand deposits offered by banks to both businesses and consumers.[52] This is—symbolically, at least—an attack on the last link with the strategy to prevent excessive lending for speculative purposes constructed by the Glass-Steagall Act fifty years ago.

While the establishment of the deposit insurance fund and the separation of banking and securities activities are remembered as the primary accomplishments of Glass-Steagall, the prohibition of interest payments on demand deposits was equally important to many of its supporters. Too many Congressmen from agricultural districts had heard complaints from constituents throughout the 1920s that their deposits were being sent to Wall Street and too little credit was available for local borrowers. Senator Glass proposed that provision of the Act because interest rate competition and the need for higher rates of return were associated with rising levels of correspondent balances in New York that made possible a burgeoning volume of call loans, margin credit and other forms of bank lending to the stock market.

---

[50] See Part III, Chapter 3.

[51] In January 1984 the FDIC and FSLIC proposed a ruling that would limit insurance coverage to $100,000 per broker per institution regardless of the number of individual deposits placed by a broker in a given institution. The U.S. district court in Washington ruled that the insurance agencies exceeded their authority, which the Court of Appeals upheld (FAIC Securities, Inc. vs. United States, U.S. Court of Appeals, D.C. Circuit Court, 84-5408, 84-5409, 84-5411, July 26, 1985). Meanwhile, the legislation passed by the Senate in September 1984 would have placed a cap on the amount of brokered deposits that could be accepted by a single institution in relation to total deposits and net worth. And subsequently, as one piece in the large package of proposals contained in H.R. 1680 (which Congressman St Germain introduced by request on March 21, 1985), the Federal Home Loan Bank Board (FHLBB) recommended that it have the authority to establish, by rule, classes of accounts, and to determine whether accounts in any such class constitute insured accounts. The FHLBB would then have the statutory authority to implement its brokered funds rule.

[52] H.R. 3535, 98th Congress, introduced July 12, 1983.

The blow to the payments system and to public confidence in the banking system as a result of the stock market crash has been documented elsewhere in this report. But it is worth noting again that, as was the case in the aftermath of the 1907 panic, a major component of reform was the effort to restore and ensure balance and impartiality in credit flows. It is an issue that has been conspicuously ignored in current discussions of changes in financial structure no less fundamental than those that took place fifty years ago.

Money market mutual funds, money market deposit accounts

As noted above, money market deposit accounts (MMDAs) were authorized by the Garn-St Germain Act of 1982 to recapture savings that had fled from depository institutions during the regime of interest rate regulation. By permitting depository institutions to pay market rates of interest on MMDAs and providing other structural changes, it was hoped that these accounts would succeed in establishing competitive equity between banks and thrifts and money market mutual funds (MMMFs).

MMMFs became an increasingly important segment of the financial services industry in the 1970s because they offered savers market rates of interest on short-term assets and, with the addition of mechanisms for withdrawal or transfers of funds, an opportunity to earn interest on transactions balances. As investments in these new vehicles for short-term savings expanded--and particularly with the growth of over $100 billion in MMMFs in 1981—there was a growing recognition that they had brought about a major reallocation of savings and credit flows and had eroded the leverage of monetary policy.[53] The high interest rate environment created by the Federal Reserve thus became somewhat self-defeating.

The borrowing sector most affected by shifts into MMMFs in 1980 and 1981 was housing because most of the savings transferred to these institutions in that period appeared to be those otherwise most likely to be deposited in thrifts, whose funds were invested primarily in mortgages. Growth in MMMFs also was at the expense of smaller banks[54] and their commercial borrowers. MMMFs invest primarily in short-term money market securities—Treasury bills, large negotiable CDs and commercial paper. Their investments in CDs and commercial paper rechanneled funds from smaller to larger banks and their holding companies, diverting funds away from regional markets and smaller borrowers.

---

[53] Because MMMFs are not subject to reserve requirements, Federal Reserve monetary operations have less effect on changes in transactions balances held in these institutions than on transactions balances held by depository institutions. Thus the absence of reserve requirements not only provided MMMFs with a cost advantage in competing with depository institutions, it also impeded the ability of the Federal Reserve to control the growth of M1 (cash and demand deposits). While redefining "money" has alleviated some of the problems of interpretation, it does not restore the effectiveness of monetary initiatives.

[54] As noted, most of the attraction of MMMFs in these years was as an interest-bearing alternative to demand deposits. Aside from the regional experiment in New England with negotiable orders of withdrawal (NOWs) by thrifts, only banks were allowed to offer checking accounts before passage of the Financial Institutions Deregulation and Monetary Control Act of 1980. By granting checking powers to thrifts and permitting banks and thrifts to pay interest on transactions balances to a limited extent, the 1980 Act helped offset some of the competitive advantages enjoyed by MMMFs in the late 1970s.

The creation of the MMDAs will help to redirect savings back to smaller and regional depository institutions and thus improve monetary control. But it is not likely to affect a restoration of previous credit flows. These institutions have to pay higher rates of interest to attract funds to their MMDAs and are experiencing higher overall costs because a substantial portion of the initial growth in MMDAs was the result of shifts from their own lower-interest-bearing accounts. Now that their costs of funds have increased they have tended to invest funds attracted to MMDAs by the deposit insurance feature in the same kinds of money market instruments in which MMMFs invested and for the same reason: the need to match interest-sensitive, short-term liabilities with interest-sensitive assets in the same maturity range. Thus smaller, regional businesses and individual borrowers and the housing sector are not markedly better off as a result of this expansion of depository institutions' powers and interest rate deregulation.

Moreover, as discussed, MMDAs have exacerbated the shift from long- to short-term financial investment initiated by MMMFs because they permit the payment of market rates of interest on *insured* short-term financial assets. Thus they have reinforced changes in financial structure that impede capital formation.

Nonbank banks

The introduction of MMDAs has helped spawn another hybrid: the nonbank bank. The nonbank bank became particularly attractive to securities firms which sponsored MMMFs as savers shifted funds back to depository institutions in 1983. The reason most securities firms have acquired or established nonbank banks is to perpetuate their money market fund business through institutions that are Federally insured. The limitation of the nonbank bank—its inability to make commercial loans [55]—is not perceived as a disadvantage in the context of this rationale for its use. But the nonbank bank does disadvantage commercial borrowers without the size and credit standing to issue commercial paper. Therefore, it poses a special threat to small businesses, whether new and innovative enterprises or established local companies that compete with large corporations in providing goods and services.

Another rationale for the use of nonbank banks is exemplified by Dimension Financial Corporation's application to the Comptroller of the Currency to establish 31 nonbank banks in 25 states. This case exemplifies the exploitation of the loophole to permit a savings and loan association to get into banking through its service corporation to evade some of the remaining restrictions on thrifts' sources and uses of funds and restrictions on interstate banking. The application was also criticized as perverting the use of commercial bank charters to divert funds away from commercial borrowers and as being potentially in violation of the Community Reinvestment Act because Dimension planned to offer services exclusively to more affluent clients. Similar charges were leveled against banks that submitted more than 300 applications after the Comptroller of the Currency lifted the moratorium on nonbank bank approvals in the fall of 1984.

---

[55] Securities firms are prohibited from affiliations with Federal Reserve member banks (which includes all national banks) by Glass-Steagall and from affiliations with all banks by the Bank Holding Company Act. But the BHCA defines the business of banking as accepting demand deposits and making commercial loans. If an institution engages in only one of these activities, it is not a bank under the BHCA and, if it is not a member of the Federal Reserve System, its ownership by firms engaged in other financial or non-financial activities is not limited by Federal Reserve rulings on permissible affiliations of bank holding companies or Glass-Steagall restrictions. This loophole has also been exploited by some financial and nonfinancial companies that have elected to make commercial loans but not receive deposits. Most nonbank banks, however, accept insured deposits, primarily MMDAs.

Those who favor the concept of nonbank banks as a vehicle for permitting limited service banking for financial and non-financial companies have proposed the establishment of so-called "consumer" banks. Some have proposed that the powers of so-called "industrial" banks owned by bank holding companies be liberalized, thus permitting banks to engage in a limited form of banking on an interstate basis.[56] The purpose of these latest variations on the nonbank bank is to equalize competitive opportunities between banks and non-bank financial services companies. But by restricting the commercial lending powers of these entities, these proposals explicitly undermine the historic mission of banks in providing business loans and could exacerbate the redirection of credit flows away from smaller regional businesses that rely primarily on bank credit.

The creation of consumer banks could have other adverse economic effects as well. As discussed elsewhere, consumer borrowing is already at a historically high level.[57] Institutional changes that increase consumer lending will further exacerbate the imbalance between consumption and investment and, in turn, exacerbate U.S. trade deficits.[58]

It is true that interest rates on consumer borrowing have remained at very high levels even as market rates of interest have declined.[59] But the argument that the creation of consumer banks will increase competition and lower the cost of consumer borrowing lacks credibility. The consumer loan market is already highly competitive. Moreover, most of the finance companies, retailers and larger bank holding company subsidiaries that offer credit cards fund their lending by borrowing in the commercial paper market at rates lower than banks' cost of funds.[60] Most financial and commercial companies likely to establish consumer banks are already consumer lenders, and while access to insured deposits may not lower their costs in financing credit extensions, it will lower transactions costs for the conglomerate as a whole by giving them access to the payments system. But lowering these costs may not induce these lenders to lower costs to consumers. Meanwhile, there is growing, if belated, pressure from consumer groups to tie rates on consumer loans to market rates which may prove to be effective.[61]

---

[56] These provisions were included in the Garn bill, S. 2181, introduced November 18, 1983, but were not included in the legislation passed by the Senate in September 1984. Subsequently, Sears floated a consumer bank proposal, introduced as H.R. 3876 by Congressman Lundine on December 6, 1985.

[57] See Part II, Chapter 4 and Table 9, Appendix A.

[58] As noted in Part I, Chapter 4, changes in financial structure and regulation to increase consumer lending are being prescribed as a strategy for reducing Japan's enormous trade surpluses. Such changes are clearly inappropriate for the United States.

[59] Most credit card holders still pay 18 percent or more ("Credit Card Deals", *The New York Times*, September 8, 1985, p. F1).

[60] Finance-related companies, including bank holding companies, have accounted for the largest share of borrowing in the commercial paper market throughout the 1970s and 1980s at rates lower than interest rates on large, negotiable certificates of deposits. (*Federal Reserve Bulletin*, Tables 1.32 and 1.35, pp. A23-A24, various issues)

THE ABSENCE OF MARKET INNOVATIONS TO FACILITATE CAPITAL FORMATION

Imperfect markets impede neutrality in credit flows. Imperfections are created by regulation, by the absence of regulation or by inequalities in competitive opportunities that result from differences in regulation. They may also come about because markets are slow to adjust to changing conditions or because of lemming-like behavior in following fads. The assumption that deregulation will do away with market imperfections is, in turn, based on the equally unproven assumptions of perfect knowledge and the ability of market participants to know and pursue their own best interests. And it is assumed that only perfectly free markets are free of imperfections. Since no one (other than theoreticians) has proposed complete deregulation of U.S. financial markets, market imperfections are likely to persist.

As the discussion in this chapter suggests, one of the more significant market imperfections that has resulted from the *ad hoc*, piecemeal process of financial restructuring to date is the imbalance between product and institutional innovations that channel short-term financial investment to borrowers and those that channel long-term financial investment to those same or other borrowers. The more important new products (MMMFs, NOW accounts and MMDAs) and institutions (money brokers and nonbank banks) discussed above have led to a rise in short-term lending by depository institutions or short-term investment by banks and nonbank financial institutions (insurance companies, pension funds, etc.) or direct investors in money market instruments or Eurodollar markets. Innovations in the securities markets, too, have shortened the time-frame for investment.[62] None of these innovations has been designed to attract long-term financial investment needed for capital formation.[63]

The link between capital formation and productivity and economic growth is well established. But these links also affect financial performance. It is in the interest of capital markets and investors to assure that funds are allocated to achieve maximum rates of growth. If economic growth depends on capital formation and capital formation depends in turn on affordable long-term funds, why have the markets failed to devise new ways to provide those funds? Why has financial innovation focused almost exclusively on providing the investor with vehicles for maximizing short-term gains?

---

[61] A spokesman for one consumer group, Bankcard Holders of America, believes that, "unless there is legislation, it is doubtful that interest rates on credit cards will go down" ("Credit Card Deals", *op. cit.*, p. F1) But *The New York Times* notes in the same article that some banks are beginning to offer lower rates, including variable rates at a given percentage above prime, to attract customers. This suggests that a competitive market exists but needs to be exploited by a borrowing sector that tends to be disorganized and sluggish in acting in its own interests.

[62] See the discussion of derivative instruments, puts and calls and high yield, non-investment grade ("junk") bonds in Part II, Chapter 4.

[63] There has been an increase in the availability of venture capital. But this is very recent, may lack stability and benefits only a narrow sector of borrowers.

Of course, that is not an entirely accurate characterization. At least in one area—housing—it is argued that the "technology" has been devised to provide long-term funds to borrowers at fixed rates and has lowered the cost of funds in the process. The development of the secondary mortgage market and increased use of mortgage-backed securities (MBS) to finance new mortgages as well as to refinance traditional mortgage lenders contrasts markedly with developments—shorter maturities and higher interest rates—in corporate bond markets.

The conclusion that a heavy government role in the development of the secondary mortgage market may have accelerated the process seems inescapable. Now, however, the prototype is being extended to other assets, including securities backed by pools of car loans, bank loans and consumer receivables. But these instruments are merely substitutes for medium-term bank loans, and their introduction will further reduce the attractiveness of long-term corporate bonds and exacerbate the current trend toward shorter maturities and higher interest rates in the market for corporate and state and local issues.[64]

SUMMARY OF POLICY CONCERNS

The fairness of access to credit and capital by different geographical regions and economic sectors, and by different income groups and borrowers of different sizes and credit standings within economic sectors, has been a continuing public policy concern in the United States and one whose importance is not likely to diminish. Structural change, interest rate deregulation, innovative technologies or any other influences that alter the distribution of financial investment are also likely to alter the channels for credit flows and revive this concern.

In the past, structural and regulatory strategies have been used not only as allocative mechanisms, but as a means to correct market imperfections resulting from credit decisions that were perceived as less than impartial. And these strategies were viewed as having important economic benefits. Assuring adequate financial services for all income groups was seen as a way of increasing the level of financial intermediation and thus the level of economic activity. Requiring portfolio diversification promoted soundness as well as access to credit by different economic sectors and by borrowers of different sizes and credit standings within a given sector. In terms of economic benefits, that strategy sought to achieve more balanced growth.

Because many of the market imperfections and distortions in credit flows that developed in the 1970s appear to have been associated with allocative mechanisms, support for increased reliance on market forces in distributing credit has grown. Those who favor deregulation as a means to obtain this objective advocate removing most structural and regulatory mechanisms that have been used to ensure a mission for specific financial sectors (e.g., thrifts: housing; securities markets: capital formation; banks: commercial lending) and a number of—if not most—Federal tax and credit programs as well. They believe that, as economic theory suggests, less regulated markets will be more competitive and efficient, and that increased competition and efficiency will result in an optimal allocation of capital and credit.[65]

---

[64] See Part II, Chapter [illegible] for a discussion of the impact of the growth of the secondary mortgage market on corporate issuers

The question arises, however: if perfect markets are the goal, will less regulation achieve that goal? As discussed above, the number and complexity of tax policies and Federal and state credit programs that interact with market forces make it unlikely that either regulated or unregulated markets will escape their influence. And the powerful influence of monetary and fiscal policies also undermines the potential for attaining perfectly free markets. Moreover, the proliferation of product and structural changes that has resulted from institutional adaptations to inflation and partial deregulation suggests that the focus on efficiency and competition in attracting funds has also been a factor in shifting the distribution of credit away from economically productive sectors. Partial deregulation has not reduced market imperfections on the lending and investing side. Will further steps in that direction result in an optimal distribution of credit from the perspective of economic activity?

The Euromarkets are perhaps the best example of how unregulated markets perform. U.S. institutions operating in these markets are almost totally free from structural and regulatory constraints. For the most part, U.S. banks and other financial institutions that operate abroad are allowed to engage in any financial activity permitted by the host authorities and, in some offshore centers, are free of any locally imposed regulations as well.[66] In the case of banks, foreign deposits have never been subject to interest rate ceilings, and are not Federally insured or subject to U.S. reserve requirements and geographic restrictions. Until 1978, banks were not subject to limits on loans to one borrower and, even today, lending limits on loans to foreign countries are more liberal than those that apply to domestic loans.

The considerable freedom from regulation enjoyed by U.S. and other multinational financial institutions has resulted in greater efficiency in moving funds and a greater degree of competition that increased the rate of return to investors and, until recently, lowered borrowing costs.[67] But the efficiency of this market depends heavily on economies of scale. Even in the 1960s, a typical Eurodollar transaction involved a round amount ranging from $1 million to $5 million.[68] Not until 1981, when some 12 percent of the more than $100 billion inflow into U.S. money market mutual funds was invested in Eurodollar CDs,[69] was access to higher Eurodollar rates available to individual investors. And access to the Euromarkets remains unavailable to all but the largest U.S. borrowers.[70]

---

[65] One expression of this view is the following:

> In the future, our shared goals for the financial system should be furthered by a twofold strategy. First, any reputable and soundly managed financial institution should be permitted to offer the public any service of a financial nature. This will insure the maximum number of competitors for the markets involved, and in turn the greatest efficiency. The public would be able to select the services which meet its needs most effectively. Full competition in the marketplace would promote the most efficient and unbiased allocation of capital by ensuring that investment decisions are the subject of vigorous competition.

(Statement of Paul V. Applegarth, Senior Vice President, BankAmerica Corporation, *Financial Consolidation: The Emerging Regulatory Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Energy and Commerce Committee, U.S. House of Representatives, April 2, 1985, Serial No. 99-21, p. 111.)

[66] While nominally subject to the monetary and prudential regulations of foreign countries, the existence of offshore centers has made avoidance of such constraints easy to accomplish. For evidence of the frequency with which one major U.S. bank avoided foreign regulatory constraints, see *SEC and Citicorp*, Hearings before the Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives, 97th Congress, 2nd Session, September 13 and 17, 1982, Serial No. 97-193, pp. 812-833.

Another result of the more relaxed regulatory environment in the Euromarkets was a rising level of concentration in terms of the number of U.S. banks involved in foreign lending and a high level of loans in relation to capital to a relatively small group of countries.[71] Some argue that concentrations in lending have contributed to global overcapacity in some industries and excess consumption in some countries while impeding the growth of others.[72] Excessive lending by Eurobanks has also threatened economic and political stability in a number of developing countries and the soundness of the financial system as well. While experience with the Euromarkets may not be conclusive, it does suggest that less regulated domestic markets will not necessarily contribute to more economically productive credit allocation or encourage institutions to exercise a greater degree of impartiality in making credit decisions.

On the other hand, many argue that the various regulatory strategies used to promote diversity and impartiality in U.S. credit decisions have contributed to the strength of the U.S. small business sector. The role that sector plays in the U.S. economy is the envy of many other industrial nations. It is the dominant source for job creation and a major source for innovations in products and services. Thus it adds flexibility to labor markets, as well as markets for goods and services, and helps stabilize the U.S. economy and the U.S. financial system. Will deregulatory initiatives such as those undertaken in the State of California—e.g., the removal of restrictions on the investment powers of thrifts that has resulted in some institutions investing up to 100 percent of their assets in a single real estate development project—provide similar economic benefits?

These are the kinds of questions that must be answered if the restructuring process is to result in a system for distributing capital and credit that is as fair—or fairer—and as responsive to requirements for economic growth as in the past. It will require an analysis of individual structural and regulatory strategies to ensure that they remain viable means for assuring impartial credit decisions by individual institutions. And an evaluation of the existing preferential structure is needed as well. Failure to examine these issues could create new, unintended distortions in capital and credit flows that may undermine valid economic objectives for assuring wider and more equitable access to financial services.

---

[67] See Part I, Chapter 3

[68] Jane Sneddon Little, "The Eurodollar Market: Its Nature and Impact", *New England Economic Review*, Federal Reserve Bank of Boston, May/June, 1969

[69] See Part I, Chapter 3

[70] The securitization of credit, discussed in Part II, Chapter 4, will undoubtedly increase U.S. borrowers' access to the Euromarkets where mortgage-backed securities are already widely accepted. However, unless securitized small business loans carry comparable U.S. government guarantees, they are not likely to be as widely accepted as mortgage-backed securities in either the domestic or Euromarkets. The success of securitized car loans issued by finance affiliates of the major U.S. automobile manufacturers will depend on the credit standing of the parent company.

[71] See Part II, Chapter 3, at footnote 43

[72] For a survey of these views, see Jane D'Arista, "Private Bank Lending: Too Far, Too Fast?", *Debt and the Less Developed Countries*, edited by Jonathan David Aronson, Westview Press, 1979

CHAPTER 2: BALANCING COMPETITION AND SOUNDNESS: THE DEBATE ON BANK DEREGULATION

INTRODUCTION

The goal of balancing competition and soundness is unique to the current debate on financial structure. In the late nineteenth and early twentieth centuries, such topics as the needs of customers and the competitive forces that shape the way financial intermediaries meet those needs were "markedly absent" from the discussion.[1] The concept that increasing competition between intermediaries would contribute to the public good by reducing the costs of financial transactions and widening the number of customers and firms involved in intermediation was eclipsed by the competitive struggles between State and Federal regulators and the anticompetitive manifestations of financial concentration. The social and economic costs of financial failures were the burning issues of the day and soundness regulation received priority attention.

Now, however, soundness regulation is seen by some as an unnecessary burden that inhibits the release of competitive forces. At the extreme are those who imply that increasing competition will displace the need for soundness regulation—or argue at least, that in a truly competitive environment, market forces rather than direct regulation, are the appropriate instruments for ensuring soundness as well as promoting competition. Others argue that soundness regulation is as important as ever, even if there is room for an enhanced role for market forces, and that changes in regulatory and financial structure must focus not only on releasing competitive forces but on resolving problems that have eroded the effectiveness of existing mechanisms for promoting soundness.

Some who have questioned the ability of current deregulatory initiatives to maintain soundness do not oppose the main thrust of those initiatives. Within limits, they favor expanding the powers of banks and other financial intermediaries and extending ownership and control of banks to other financial intermediaries. They also favor changes in the regulatory framework to accommodate a greater consolidation of financial functions and rationalize existing overlaps and similarities in products offered by different types of intermediaries. And they advocate an enlarged role for market forces in disciplining excessive risk-taking. But they are skeptical that these solutions will do the whole job. Like a growing number of opinion and policy makers in finance, they are unwilling to jettison the role of *direct* regulation as a tool for promoting soundness.

---

[1] Stephen J. Friedman, "A New Paradigm for Financial Regulation: Getting from Here to There", Address to the University of Maryland Law School, May 26, 1983, p. 3 (This address was subsequently revised by Mr. Friedman and Connie M. Friesen and published under the same title in *The Maryland Law Review*, Vol. 43, No. 3, 1984).

At the present moment, however, the major spokesmen for this view have offered only a "sketch of the desired structure." [2] For the most part, the details are missing. But they have raised important questions about the potential effectiveness of deregulatory initiatives in promoting soundness. Their contribution is to point up the need for balancing competition and soundness and to provide a counterweight for a debate that has focused primarily on the benefits of releasing competitive forces.

This chapter is an effort to review the debate to date. It begins by defining the links between soundness regulation and competitive restraints, discusses the relationship between various deregulatory initiatives and soundness concerns and concludes by addressing the primary policy concern that has emerged in recent discussions: the need to reconstruct the financial safety net.

Because it addresses the proposals on the table around which the debate is framed, the discussion tends to focus on the issue of deregulating depository institutions. But the concerns that have emerged reveal that it has become more difficult to confine the debate to banking. Increasingly, the focus appears to be shifting to concerns about the need to balance competition and soundness within the financial system as a whole. And as product and institutional consolidation proceeds—either through an expansion of banks' powers or because insurance, securities and commercial firms increase their use of innovative products and activities to gain access to banking functions and the payments system—many of the same concerns discussed here will necessarily apply to nonbank financial sectors as well. Meanwhile, evidence that this shift in focus is already occurring can be found by comparing the 1941 statement that opens Part II of this report with the following restatement of its themes by Dr. Henry Kaufman:

> . . . the drive over nearly two decades in support of financial deregulation still has substantial momentum. On the other hand, a new and not-yet-coherent effort to reregulate has surfaced. At the heart of the debate about deregulation versus reregulation are fundamental issues that concern the roles of financial institutions in our society. On the one side is the view that financial institutions should be subject to the discipline of the marketplace, to its risk and to its rewards, and thus to prosper or perish. Others, like myself, believe that financial institutions play a unique role as intermediaries between suppliers and demanders of credit. They are holders of savings and temporary funds. Through intermediation, they finance many activities. In this function, they must always balance their

---

[2] Bevis Longstreth, "In Search of a New Safety Net for the Financial Services Industry", March 17, 1983, (article included in *FDIC Securities Proposal and Related Issues*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, June 16, 1983, Serial No. 98–46, p. 105.)

The "sketch" to which former Commissioner Longstreth refers was offered by Robert V. Roosa in "International Financial Crisis" (remarks before the Institute on International Banking and Finance, Southern Methodist University, November 10, 1982). Mr. Roosa called for the development of a regulatory structure that is based upon "the reinforcing of market processes through governmental action, and upon containing the apparent excesses to which imperfect freedom sometimes contributes". Mr. Longstreth's own structural outline is discussed below.

enterpreneurial drive with their broader fiduciary responsibilities. They have both a public and a private obligation.[3]

SOUNDNESS REGULATION AND COMPETITIVE RESTRAINTS

Soundness regulation is concerned with preventing financial crises by preventing conditions that lead to "a mass rush to liquidity". It reflects the concern "that liquidity vanishes with a sudden preference by *all* economic units to liquidate their financial assets at a particular point in time". It is an acknowledgement that the "susceptibility of the financial sector to such upheavals, its fragility, is one of the externalities that justifies some form of government intervention".[4]

The basic elements of soundness regulation are applicable to almost all sectors of the financial services industry in varying degrees. They include:

(1) prohibitions on self-dealing;

(2) restrictions or requirements relating to the nature and quality of assets;

(3) regulation of the liability structure of intermediaries including capital, reserves and liquidity requirements, and

(4) controls on engaging in other kinds of businesses.[5]

Soundness regulation differs from what former SEC Commissioner Bevis Longstreth terms "post failure mechanisms" such as deposit insurance and similar loss-guaranty funds.[6] Post-failure mechanisms are intended to protect the customers of financial intermediaries from crippling losses resulting from financial failures.[7] Soundness regulation is intended to promote systemic stability by providing safeguards against excessive risk-taking by intermediaries and ensuring their ability to withstand short-term financial shocks.

These safeguards necessarily act as a restraint on competition. They limit the investment opportunities of intermediaries and the asset and liability products they can offer. More important, they limit the profitability of financial firms by restricting their ability to leverage operations and expand into new areas. Their removal is therefore a primary objective of advocates of a more competitive financial environment.

But, as competitive restraints are relaxed, "banks and other financial institutions necessarily become exposed to greater risks"; and because "deregulation often involves abandoning precisely those regulatory devices designed to promote soundness"[8]—particularly those involving controls on engaging in other kinds of businesses which, in turn, affect existing prohibitions on self-dealing—the issue of balancing competition and soundness has moved to the forefront of the debate.

---

[3] Henry Kaufman, Executive Director, Salomon Brothers, Inc. and Vice-Chairman, Phibro-Salomon, Inc., "Dangers in the Rapid Growth of Debt: The Need for a National Policy Response"; talk delivered before the National Press Club, Washington, D.C., January 16, 1985, p. 13.

[4] William L. Silber and Kenneth D. Garbade, "Financial Innovation and EFTS: Implications for Regulation", *Compendium of Papers Prepared for the FINE Study*, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Cong., 2nd Sess., June 1976, p. 197.

[5] Friedman, *op. cit.*, p. 14.

[6] Bevis Longstreth, "Why Free Markets and Banks Don't Mix", *The New York Times*, May 29, 1983, p. F3.

Mr. Longstreth's definition of soundness regulation is similar to that outlined above: it "includes restrictions on how financial intermediaries such as banks, brokerage firms and insurance companies can compete in the marketplace, as well as restrictions on how portfolios can be managed".

[7] These mechanisms are discussed in Part III, Chapter 3 of this report.

Soundness regulation has tended to focus most heavily on depository institutions and particularly on banks. The unique power of banks (and now all depository institutions) to issue deposits payable at par on demand is considered central to the functioning of the financial system and the economy as a whole because it enables banks to provide liquidity to all financial and non-financial sectors.

However, depository institutions that issue demand deposits payable at par are subject to significant risks because they can never completely match the maturity or "term structure" of their assets and liabilities. Even by relying on secondary markets, they cannot be certain that highly liquid investment grade assets such as government securities can be liquidated at cost. Thus, depository institutions that issue interest bearing demand deposits are subject to a greater risk than money market mutual funds whose "deposits" are not legally payable at par.

In recognition of both the risk and the essential nature of this function, a financial safety net consisting of deposit insurance and direct access to central bank loans is uniquely available to depository institutions. Their monopoly on transactions accounts that are backed by governmental financial resources "implies that those institutions have a particular responsibility to conduct their affairs in a safe and prudent manner"[9] and justifies, in the view of many, direct government intervention through regulation to promote soundness.

Banks (and other depository institutions) are subject to periodic examinations to assess the quality of their assets. They are required to limit loans to individual borrowers to a certain percentage of capital. They pay a franchise tax for the right to use other people's money in the form of reserve requirements that limit the amount of funds that can be loaned and therefore limit the profitability of a given level of liabilities. Reserves, like capital, act as a cushion against the withdrawal of deposits. Reserve requirements also constitute the mechanism by which banks act as the "transmission belt" for monetary policy. Holding non-interest bearing reserves raises the cost of attracting funds but is at least partially offset by access to government backing (the Federal Reserve discount window and deposit insurance) which reduces these costs.

---

[8] Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op. cit.*, p. 100. See also the excerpt from an article by Professor Robert C. Clark, below at footnote 17.

The counter statement to these positions is that: "The enactment of legislation deregulating depository institutions holding companies would strengthen our financial system by promoting safety and soundness and providing competitive equality" (Statement of Thomas J. Healey, Assistant Secretary for Domestic Finance, Department of the Treasury, *Financial Restructuring: The Road Ahead*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, May 17, 1984, Serial No. 98-144, p. 351). As a similar statement by the American Bankers Association makes clear, what is meant by "deregulation" is an expansion of powers: "Expansion of bank services through the bank holding company vehicle ensures preservation of the safety and soundness of our banking system, a major economic policy goal" (*Ibid.*, p. 317). It would do so because it creates "opportunities to develop substantial new sources of earnings . . . strengthens a bank holding company's capacity to absorb losses . . . enhances the company's ability to generate the additional capital needed to support asset growth and to retain the confidence of the markets . . . [and thus] would increase the system's stability (*Rethinking Glass-Steagall*, J.P. Morgan & Co., Inc., December 1984, p. 22).

These and similar statements assume that existing regulations, other than those affecting the powers of financial institutions, would not be relaxed, and that current regulations are adequate to prevent conflicts of interest and other abuses that undermine soundness and that might occur if financial functions are consolidated (See, for example, *Rethinking Glass-Steagall, op. cit.*, pp. iv, 18-19, 29). That assumption is discussed below and in Part II, Chapter 3.

[9] E. Gerald Corrigan, former President, Federal Reserve Bank of Minneapolis, Answers to Questions Submitted by Chairman Wirth, Hearings on *The FDIC Securities Proposal and Related Issues*, *op. cit.*, June 28, 1983, p. 206.

Depository institutions have previously been insulated from competition by the fact that other financial intermediaries have been prohibited from undertaking banking functions, by interest rate regulations that have limited competition among depository institutions, by restrictions on branching within and between states, and by chartering requirements that have, as one of their effects, prevented "overbanking".

Banks have chafed at competitive restraints imposed by soundness regulation since the 1960s, and large banks have succeeded in circumventing many restrictions by expanding their overseas operations.[10] On the other hand, their monopoly on transactions accounts has been eroded by the growth of money market mutual funds (MMMFs) and cash management accounts offered by securities firms. They have also increasingly felt the need to compete with diversified financial services firms offering consumers and businesses loans that are similar to those offered by banks. And, ironically, the loosening of regulatory restraints on interest ceilings on deposits has intensified pressure from banks to expand the range of nonbanking services they are allowed to offer. As the FDIC recently noted, because banks "can no longer rely on low cost deposits as a source of funds to generate income . . . (they) are considering entry into . . . other activities as a way of expanding their sources of income".[11]

But banks are not the only intermediaries affected by the anticompetitive restraints of soundness regulation. While there may be differences in degree, other financial services firms are also subject to capital requirements, licensing requirements, examination and asset restrictions. For example, limits on insurance companies' investments in equities under state law are intended to protect these intermediaries from volatile changes in stock prices. But they also have the effect of limiting potential earnings. Margin and net capital requirements are soundness devices that have the effect of limiting the volume of trading by individual securities firms and thus limiting their potential profits.

There have been equally powerful restraints on the kinds of businesses other intermediaries can engage in. The fact that banks have not been allowed to engage in certain other financial activities has had a symmetrical effect on other intermediaries: they cannot engage in banking functions.[12] Following the findings of the Armstrong Commission appointed in 1905 to investigate the life insurance industry in New York, companies located in that state were confined to the business of life insurance.[13] The more liberal treatment accorded life insurers, as well as property and casualty companies, by other states notwithstanding, many of the largest life insurance companies and most of the largest securities firms are located in New York, and the effect of New York law—together with a New York Stock Exchange requirement (in effect until 1970) that Member firms be organized as partnerships [14]—was to institute as firm a separation between insurance and securities activities as that governing banking and securities under the Glass-Steagall Act.

---

[10] There are no reserve requirements or [illegible] assessments on foreign branch deposits, for example, and restrictions on the kinds of financial businesses in which banks can engage overseas are minimal. Moreover, banks that are restricted to branching within a single state are nevertheless permitted to have branches in any number of other countries around the globe.

[11] Memorandum to the Board of Directors of the FDIC from the [illegible] re: Advance Notice of Proposed Rulemaking Soliciting Comment on the Need to Regulate with Regard to Direct or Indirect Involvement by Insured Banks in Real Estate, Insurance, Data Processing, Travel Agency Activities and Other Financially Related Activities, August 12, 1982, p. 2.

But with the movement of a New Jersey insurance company (Prudential/Bache) into securities and other financial activities, the 1982 Report of the Executive Advisory Commission of the State of New York on Insurance Industry Regulatory Reform concluded that in "order for New York to continue to have a viable insurance industry, its companies must be able to compete in the broader environment of financial services". Its recommendation that insurance companies be permitted to invest up to 10 percent of their assets in subsidiaries engaged "in any lawful business" was enacted into law in 1983—an indication that pressures for a relaxation of restraints on permissible activities have not been confined to banks.[15]

As restraints are loosened, the pressure for deregulation appears to increase. It seems that, the more competitive the environment, the greater the need to expand competitive opportunities and reduce regulatory inequality. But one observer believes this may not be the case—that some financial sectors will resist the "level playing field" in favor of preserving existing advantages.[16] Another believes that resistance ". . . is simply a matter of fear of competition from large financial institutions".[17] But anti-competitive restraints also contribute to stabilizing income; some resistence to the level playing field reflects concern for financial stability and continued viability. The impact of the end of negotiated rates on the securities industry is an example of how the relaxation of anti-competitive restraints—however justified—can erode profits and increase risk.[18] In terms of soundness, the financial stability of intermediaries is not an unimportant concern.

---

[12] In a letter to the Subcommittee of June 5, 1985, Stephen J. Friedman noted ". . . to say that securities firms and insurance companies cannot take deposits is only true in a technical sense. Universal life is a deposit-like product, as are Merrill Lynch's CMA and money market funds offered by securities firms."

For a further discussion of bank-like products offered by securities firms, see Part III, Chapter 1.

[13] Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op. cit.*, p. 100.

[14] As discussed in Part I, Chapter 2, the NYSE's action in revoking this rule made it possible for securities firms that converted to stock corporations to form or acquire other financial and non-financial companies as well.

[15] *Ibid.*, pp. 99-100.

[16] Bevis Longstreth, "Open Letter to Bush Task Group on Regulation of Financial Services and Wirth Commission on Capital Markets", remarks to The American Assembly, Columbia University, New York, NY, April 8, 1983, p. 3.

[17] Friedman, *op. cit.*, p. 16.

DEREGULATION AND RISK

The implications of deregulation for risk underscore the need to achieve balance between increasing competition and maintaining soundness. For example, the upheaval in the securities industry following the end of negotiated rates was successfully weathered and the consensus view is that the benefits to customers have been substantial.[19] But the trade-offs—the proliferation of mergers and increased concentration of securities underwriting in the top 25 firms—have not been inconsequential.[20] The potential risks of losses to banks associated with interest rate deregulation may also result in adverse tradeoffs. As Federal Reserve Bank President Corrigan observed:

> In today's deregulated environment, all banks, small and large, must learn to better match the maturities of their assets and liabilities and to better manage their interest spreads over the interest rate and business cycle. However, even as this adjustment is made, in the current deregulated environment, banking organizations may be potentially more vulnerable to sudden deposit drains because new deposit instruments such as MMDAs and Super NOW Accounts are, as a practical matter, payable on demand. While we do not have any real experience to judge how stable these funds will be over the interest rate cycle or how stable they will be when a bank encounters problems.

---

[18] As *Businessweek* notes, the result of the erosion of profits on commissions has been that "Brokerages now generate more revenue trading for their own accounts than they do in commissions, once the main source of income." And as the securities industry shifts "from servicing customers to positioning itself to profit from the market's never-ending swings," it also increases its exposure to loss (Anthony Bianco, "Playing With Fire", *Businessweek*, September 16, 1985, p. 83).

[19] As the above footnote and the discussion of the decline in individual shareholders (Part II, Chapter 4) suggest, however, the presumed benefits to customers have not had the effect of increasing the number of individuals—the intended beneficiaries of actions ending negotiated rates—that participate in the markets.

[20] As discussed in Part II, Chapter 4, one of the effects of this deregulatory action was that—unlike others that have tended to consolidate financial functions—it has tended to separate the underwriting and distributing functions within the securities industry. This results from the fact that smaller, retail broker-dealers are less profitable and, with the advent of shelf-registration, no longer have sufficient capital to participate in underwriting syndications to the same degree as in the past, and that discount brokers affiliated with depository institutions are restricted from underwriting activities. Thus, securities underwriting has become more concentrated. Data on underwriting revenues show that the share of total securities industry underwriting revenue earned by the top 25 firms was 52 percent in 1971, 67 percent in 1975, 68 percent in 1980, 81 percent in 1982 and 76 percent in 1983 (Data provided by the Securities and Exchange Commission and the Securities Industry Association, compiled and included in *Rethinking Glass Steagall, op. cit.*, p. 31. See also Part II, Chapter 3, Table 5).

Perhaps some of these adverse effects developed because ending negotiated commissions—a delayed response to fatter, happier days in the securities industry in the 1960s—occurred during a recession when equity values were at historically low levels for the post-Depression era. Nevertheless, there is a growing perception that deregulatory initiatives affecting the securities industry have involved significant tradeoffs between benefits and costs. As described by *Businessweek*, the domestic securities market has become more like the Eurobanking market:

> Deregulation hastened the trader's rise to preeminence. After brokerage commissions were unfixed in 1975, successive waves of price-cutting swamped the Street. New SEC rules to streamline securities underwriting also squeezed profit out of this mainstay business. Today, the markets are dominated by a half-dozen giant brokerages able to wield massive blocks of securities for a quarter-point profit here and an eighth there.

(Bianco, *op. cit.*, p. 83).

> this situation requires careful monitoring. In short, and abstracting from all the fine points, I believe it does follow that less regulated banks are, by their nature, at least marginally more risky.[21]

In other words, banks and thrifts, previously sheltered from the risks of market fluctuations, were—and are—no longer. And that adds considerable new risk to traditional banking activities. In the case of thrifts, "High inflation and unregulated interest rates suddenly thrust the risks of the market into the middle of the mortgage business." [22]

The expansion of financial intermediaries into additional activities also entails additional risks if only because the managerial skills required to conduct or supervise new activities must be developed. But staunch advocates of deregulation reject the notion that some activities entail excessive risk *per se*. They argue that underwriting corporate securities—traditionally viewed as the most risky financial activity—is not inherently subject to more risk of loss than traditional banking activities such as underwriting Treasury and municipal securities, foreign exchange trading or foreign lending; that these current activities, in fact, are not risky and neither are the new activities proposed. The real risk, according to proponents of this view, is "traditional bank lending, which involves credit exposure for a number of years and relatively illiquid assets".[23]

Others argue that while the risks of expansion are real, they can be managed by new forms of direct regulation—the FDIC proposals governing the underwriting activities of state non-member banks, for example—or by using legal structuring to isolate different activities. Proponents of this view would not necessarily deny that traditional bank lending is risky. Indeed, if it were not, there would be no need for deposit insurance or direct supervision and regulation. But the issue is how to isolate traditional bank activities, where risk to the customer is cushioned by government backing, from other activities where the risks are at least as great but where government protection for customers is not.

As these views suggest, the issue of risk is not easily quantified. Federal Reserve Board Chairman Volcker has observed that activities that might not be viewed as risky at one point in time may become more risky under different economic conditions, making it difficult to determine the degree of risk in advance.[24] Objective lists of more or less risky activities are difficult to come by. The Federal Reserve's General Counsel believes the "decision is essentially a judgemental one." [25]

---

[21] Corrigan, Answers to Questions Submitted by Chairman Wirth, *The FDIC Securities Proposal and Related Issues, op. cit.*, June 28, 1983, p. 207.

[22] Statement of Robert E. Linton, Chairman and Chief Executive Officer, Drexel Burnham Lambert, Inc., *Financial Restructuring: The Road Ahead, op. cit.*, p. 605.

[23] *Rethinking Glass-Steagall, op. cit.*, p. iv.

[24] He noted for example, that loans in the energy, shipping, agricultural and real estate areas have turned out to be risky in a period of transition from high inflation to lower inflation (John M. Berry, "Volcker Urges Congress to Restrict Savings and Loan Activities", *The Washington Post*, September 12, 1985, p. B1).

[25] Interview with Michael Bradfield, *Insight* (Clifford C. Brody, Editor), Vol. 7, No. 17, September 2, 1985, p. 5.

Continued

Nevertheless, as discussed elsewhere, greater risk is often associated with other areas of regulatory concern such as conflicts of interest and the concentration of financial resources.[26] Thus it is not surprising that—other than in the area of interest rate deregulation—the issue of deregulation and risk is most often discussed in the context of proposals for managing risk by segregating functions within the legal structure of a financial conglomerate. Implicit in such a strategy is the assumption that consolidating financial functions does, in fact, entail additional risk both because of the increased potential for conflicts of interest and because of the probability that losses in one line of business will result in a withdrawal of resources from another affiliate and undermine its profitability unless explicit safeguards are provided.

The separate subsidiary structure has been widely embraced by advocates of deregulation (i.e., expanded powers) as an adequate and optimal solution to the problem of managing risk, however defined. Indeed, it is the only proposal that has been offered (other than those that would retard the momentum toward consolidating financial functions) and has formed the basis for the restructuring proposals advocated by the Treasury and adopted by the Senate in 1984.

The Treasury and Senate bills provided for an expansion of banks' activities (and, symmetrically, for ownership of banks by firms engaged in the expanded range of activities) through subsidiaries of the banks' holding companies (BHCs). It is argued that the legal separation of banking and other activities, coupled with restrictions on transactions between the bank and its affiliates, would serve to insulate the bank from losses incurred by affiliates. Presumably, it would also protect nonbanking affiliates from losses incurred by the bank in cases where the bank is not the dominant entity in the holding company.

The BHC subsidiary structure appears to conform to the view that banks perform essential functions within the financial system and for the economy as a whole, and that these functions should remain segregated. It would also appear to satisfy those who argue that banks should be given opportunities to compete with diversified financial services firms. But it might not provide a way for banks to expand the sources of their income. Banks would still be banks and profits from additional activities would largely benefit the holding company and its shareholders. The managers of successful nonbanking affiliates might be unwilling to provide new capital to banks rather than retain earnings for their own growth.[27] It could be argued that recent FDIC rulings suggest a

---

Two examples of risky activities offered by Mr Bradfield are insurance underwriting and real estate development "These are clear and obvious examples of activities that involve more than normal risk, as well as the possibility of conflicts of interest, particularly in the case of real estate development" (*Ibid.*, p 5).

[26] See Part II, Chapter 3.

[27] One advocate of expanding banks' powers argues that " corporate securities activities generate substantially higher returns on capital employed than commercial banking activities and carry no great risk"; they therefore, provide a "reliable revenue stream" that will strengthen banks' capital position (*Rethinking Glass Steagall, op. cit.*, p 22). In other words, this argument suggests that, because securities activities require less capital to generate a given level of profits than do banking activities, more of the earnings generated by the diversified financial conglomerate will be used to increase the capital of its banking subsidary

Continued

structural alternative that would obviate this concern. By ignoring the BHC structure and assuming that new activities will be undertaken by subsidiaries of the bank itself, the FDIC also appears to assume that these activities will increase bank profits.[28]

Profits are necessary to maintain the viability of the banking or any other financial services industry. Excessively risky activities are those that involve a greater likelihood of loss and therefore threaten the viability of a firm or industry. If banks perform essential services, their viability is a public policy concern as are any risks that are likely to result in losses. Currently profits are up for some banks as a result of higher fees and other charges. However, the overall profitability of the industry has been declining for more than a decade and profits continue to be threatened by the impact of interest rate deregulation on spreads between loans and liabilities, by losses on energy and agriculture loans and potential losses on loans to developing countries. These dangers undoubtedly contribute to pressures for expansion into activities which currently appear to be more profitable than banking. But, as the following excerpt from the FINE Study indicates, this situation is not new and the advice the author offers is by no means outdated:

> The public interest is heavily affected by the spread of banking into commerce on the one hand, and on the other, by the need for a banking system which not only is sound but which also is not so aggressive and "swinging" that it adds to inflation in one cycle, and then in the next interferes with recovery because it must heal its own wounds before it can renew its lending to others. Protecting those public interests requires that we stand apart from cycles of applause or alarm, and examine structural aspects which

---

Such an assumption is obviously open to question. Why should the earnings of a more profitable subsidiary be used to promote additional activity on the part of a less profitable line of business? Do corporate securities activities (or any other financial or nonfinancial activities) *always* provide a "reliable revenue stream"? For example, were securities firms' profits in the 1970s either "reliable" or as high as those of banks operating in the (then) lucrative Eurodollar market? Is any financial or nonfinancial activity immune from the vicissitudes of the business cycle and is there any real assurance that earnings cycles for various financial and nonfinancial activities vary enough so that a diversification of activities will provide the systemic stability that advocates of consolidation proclaim?

Portfolio diversification as a means for stabilizing profits was used as a rationale for expanding foreign lending in the early 1970s. Then the assumption was that different countries would experience different phases of the business cycle at different times. However, as national and international markets became increasingly integrated, the simultaneity of the business cycle in a world linked by dollar prices and payments for oil erased the presumed protection afforded by this diversification strategy. Similarly, as the consolidation of financial functions and markets increases, it is less likely that variations in earnings within a diversified financial conglomerate will maintain stability. Financial sectors will be more likely to experience peaks and troughs in profits simultaneously.

[28] A 1984 Congressional staff analysis of Continental Illinois indicates that, in many years, profits were used to finance an aggressive expansion into non-banking activities, contributing to an erosion of the bank's capital. Moreover, when the bank's problems surfaced in 1982, they contributed to a reduction in the earnings of the subsidiaries because of the difficulties the subsidiaries and the parent company encountered in raising funds in the commercial paper market. The history of Continental Illinois suggests that the fortunes of subsidiaries (whether owned by the bank or the holding company) are so closely linked to those of the bank as to preclude the possibility that nonbanking activities can serve as an alternative source of income and capital for banks if the bank itself is experiencing problems. ("The Financial Performance of Continental Illinois National Bank: A Chronology and Peer Group Comparison," *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank*. Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 98th Congress, 2nd Session, September 18, 19 and October 4, 1984, pp. 7–73)

> are permanent and show us where the dangers or abuses emerge, and where the benefits can be made yet more secure.[29]

As banks have renewed their pressure for an expansion of activities, most regulators have agreed that some expansion is warranted. But not all are persuaded that it is possible to insulate banks from the risk of losses involving nonbanking activities through the BHC or subsidiary structure. SEC Chairman Shad has questioned whether banks can "afford" to let their subsidiaries fail.[30] President Corrigan agrees—"particularly when it is recalled that some bank sponsored REITs[31] were not even legally a part of the banking organization",[32] and concludes that "the holding company structure is neither a substitute for prudent management nor a fail-safe device for containing risk".[33] And former SEC Commissioner Longstreth urges—

> . . . the closest scrutiny of proposals that seek to protect firms through legal structuring. Whether it be through subsidiary, holding company affiliate or whatever, I have serious reservations as to whether such legalities can adequately immunize the financial intermediary from the risks determined to be incompatible with soundness.[34]

And another former SEC Commissioner also questions the efficacy of the subsidiary device:

> Bankruptcy lawyers will tell us that, in a complex company, the use of separate subsidiaries does not protect individual operations from the effect of financial problems elsewhere in the company. Witness, for example, the impact of adverse publicity about the problems of Baldwin-United Corporation on the level of sales and redemptions of Single Premium Deferred Annuities by its life insurance subsidiaries.[35]

Because of these concerns, President Corrigan suggests that "we should not be indifferent to the scope of financial services offered by banking organizations."[36]

INTERDEPENDENCE AND SYSTEMIC RISK

The same group that has pressed for the need to balance competition and soundness has also repeatedly called attention to the emergence of new systemic risks resulting from increased interdependence within the financial services industry and other factors. President Corrigan has offered one assessment of these developments from the point of view of banks:

---

[29] Roy A. Schotland, "Bank Holding Companies and Public Policy Today", *Compendium of Papers Prepared for the FINE Study*, *op. cit.*, p. 248.

[30] Shad, *The FDIC Securities Proposal and Related Issues*, *op. cit.*, June 16, 1983, p. 36.

[31] REITs (real estate investment trusts) were sponsored and managed but not owned by banks. Nevertheless, many REITs bore the same names as their bank sponsors. During the REIT crisis in the mid-1970s when a rising number of properties could not be sold, many banks made loans in excess of the 10 percent limit to the REITs they had sponsored because they feared that the collapse of a REIT would undermine public confidence in the managerial competence of the bank itself. For a further discussion of the REIT problem, see Part II, Chapter 3.

[32] Corrigan, Answers to Questions Submitted by Chairman Wirth, *The FDIC Securities Proposal and Related Issues*, *op. cit.*, June 28, 1983, p. 207.

[33] Corrigan "Are Banks Special?", *Annual Report 1982*, Federal Reserve Bank of Minneapolis, p. 18.

[34] Longstreth, "Open Letter . . .", *op. cit.*, p. 12.

[35] Friedman, *op. cit.*, p. 15.

[36] Corrigan, "Are Banks Special?", *op. cit.*, p. 17.

> Financial affairs generally are much more complex and more interdependent than they once were. One consequence of this is that when problems arise they are more difficult to isolate and contain than in the past. Perhaps more importantly, the combination of liability management techniques and deregulation has significantly altered the overall liability structure of banks. Stable and low cost core deposits are virtually a thing of the past. These developments have, in combination with more sophisticated and interest-rate conscious corporate treasurers and individuals, increased the term structure risk at banks and made banks more susceptible to sudden deposit shifts. At the same time, "spread management"—whereby banks attempt to float the rate of return on assets in some reasonably fixed relationship to changes in the cost of funds—may, subtly but insidiously, be working to undermine the traditional disciplines of both borrowers and lenders. Finally, the far-flung international activities of banks have introduced new elements of risk into the equation. While it is a matter of judgment as to whether this crosscurrent of events is working to reduce or to increase the risks associated with the activities of banks, it does seem prudent to conclude that they are working in the direction of creating greater risks.[37]

Former Commissioner Longstreth has described the way that technological innovations enhance interdependence and increase risk:

> The velocity with which funds can move contributes to the vulnerability of the financial system. When the objective is to achieve maximum investment over relatively short periods of time, the cushion of cash reserves is reduced, and the time available to respond to a fail is severely curtailed. The problem is sharpened if commitments to deliver are matched against expectations of receipt. System-wide liquidity problems can result.[38]

In the same article, Mr. Longstreth quantifies the extent of interdependence involved in some recent threats to systemic stability:

> Paine Webber had inter-firm debits and credits totalling some $155 million as well as repurchase and reverse repurchase agreements with banks and broker-dealers of $3.6 billion in the spring of 1980 when its viability was threatened by its merger with Blyth Eastman Dillon & Co.
>
> At the height of the silver crisis in the spring of 1980, Bache—the most seriously threatened of the large broker-deal-

---

[37] *Ibid.*, p. 16.

[38] Bevis Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op cit.*, pp. 96-97.

> ers that had extended credit to the Hunt brothers—had inter-firm debits and credits of approximately $250 million and repurchase and reverse repurchase agreements with banks and broker-dealers of almost $2 billion.
>
> Between its incorporation in January 1982 and its bankruptcy four months later, Drysdale Government Securities had accumulated a gross long position in excess of $2.5 billion and a gross short position of about $4 billion with a capital base of approximately $20 million.[39]

Some have argued that Bache and Drysdale's problems could have set in motion a chain reaction of failures. Because inter-firm transactions are the equivalent of cash, their loss results in defaults on other inter-firm transactions that widens the circle of non-payment to institutions not directly involved with the problem firm. These ripple effects are difficult to contain once started. Without Federal Reserve intervention in each of these cases, the failure of these firms could have resulted in a systemic crisis involving a series of broker-dealers, commodities firms and banks.

Continental Illinois' problems, however, posed an even larger threat of a systemic chain reaction because a greater number of institutions and a larger volume of transactions were involved.[40] Continental provided correspondent banking services for 2,000 small banks throughout the Midwest with millions in deposits. Interbank transactions between Continental Illinois and other large banks amounted to many billions of dollars. Closing the bank was never an option.[41] It would have frozen a significant portion of the liquid funds held by other banks with Continental Illinois and set off a scramble among banks to withdraw funds from other correspondents. An implosion of the interbank market of the magnitude that might have occurred in the case of Continental Illinois would have precipitated a credit contraction of even greater magnitude.

As Mr. Longstreth has noted, these "are examples of how, with increasing frequency, the difficulties of a single financial institution threaten to trigger a chain reaction, extending well beyond the entities immediately involved." [42] And he observes that the "vulnerability of our financial system is likely to be further exacerbated by what appears to be the emergence of a trend toward consolidation and growth in the size of financial intermediaries." [43] He sees the possibility that an expansion of firms into other financial services will intensify the effects of interdependence because a company

> . . . of greater size and diversification of business line . . . has more linkages that can cause its failure to impact adversely on others, as well as the failure of others to impact adversely on it. And like ships, whose size is measured by the water they displace, the larger the firm, the

---

[39] *Ibid.*, pp. 92-94.

[40] Continental Illinois' liquidity problems are discussed below and in Part III, Chapter 3.

[41] That does not mean, however, that there were not ways of keeping the bank open other than the one adopted by the FDIC.

[42] *Ibid.*, p. 95.

[43] *Ibid.*, p. 97.

> greater the displacement of those around it, when failure comes.[44]

These observations suggest that current deregulatory initiatives involving a relaxation of restraints on the kinds of businesses in which financial firms can engage may not only increase risks to individual firms or segments of the financial services industry; they may threaten the stability of the system as a whole. If so, the need to devise ways of minimizing or managing risk should be a paramount concern in the discussion of financial and regulatory restructuring.

SUBSTITUTING MARKET FORCES FOR DIRECT REGULATION

As deregulation proceeds, it is inevitable that, as former Comptroller of the Currency C.T. Conover stated, "some of the responsibility for discipline of banks (will shift) from regulators to the marketplace."[45] But:

> . . . In order for the discipline of the marketplace to operate efficiently and to provide adequate safeguards against excessive risks, market participants must have all necessary information to conduct meaningful risk analysis. Disclosure, then, becomes an integral part of the free market model.[46]

A major assumption of those who advocate increased market discipline is that it will increase efficiency. Not everyone would agree. Professor Robert C. Clark of Harvard Law School argues:

> Indeed, a major efficiency advantage of financial intermediation is *precisely* that it frees capital suppliers from having to know about portfolio management and the relative merits of specific issuers of securities. Their only investment decision is whether to relinquish funds to a particular intermediary. It would make little sense, obviously, to hold capital suppliers at their own peril to assess and assume whatever risks were presented by the intermediaries, since that would force them to duplicate the portfolio managers' efforts and thus defeat the scheme. Moreover, many individual capital suppliers could be quite distressed by adverse fluctuations in their share of capital income. The basic regulatory approach to this situation can be summed up in the concept of soundness. By a variety of methods, public suppliers of capital are insulated from the consequences of financial failure of intermediaries. This general aim has clearly and consistently been the generative, unifying force behind a staggering multiplicity of laws and regulations affecting banks, insurance companies, and the like.[47]

---

[44] *Ibid.*, p. 98.

[45] Remarks of C.T. Conover before the SEC Major Issues Conference, October 7, 1982 (quoted by Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op. cit.*, p. 100).

[46] Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op. cit.*, p. 100.

[47] Robert Charles Clark, "The Four Stages of Capitalism: Reflections on Investment Management Treatises", *Harvard Law Review*, Vol. 94, No. 3, January 1981, p. 571.

Nevertheless, the need for increased market discipline has been widely accepted and most of the current discussion is focused on banks. The securities laws exempted banks from disclosure—the "traditional reason . . . (being) to avoid 'runs on the bank' flowing from disclosure of adverse events."[48] But with the advent of the bank holding company structure and the determination that BHCs are subject to the registration and disclosure requirements of the securities laws, a great deal of information about large and medium-sized banks has been available for some time. On the other hand, as discussed in Part III, Chapter 2 of this report, much of the information BHCs are required to report on their banking subsidiaries is determined by bank regulators, rather than the SEC, and disclosure is not comparable to that required for other firms. More information is needed if investors are to make informed judgments, and the change in attitude of bank regulators toward disclosure as well as recent changes in the amount and kinds of information collected and made available to the public suggest that the ability of analysts to conduct meaningful risk analysis of banks is improving.[49]

Until recently, few regulators, market participants or financial intermediaries openly opposed increased disclosure for banks.[50] Most appeared to agree that there "is no reason why disclosure should not have the same salutary effect on financial institutions as it does in other sectors of the economy."[51] It was noted that the experience with disclosure of banks' problem loans to developing countries has not caused runs on banks.[52] And the run on Continental Illinois did not occur until almost two years after its disclosure of losses on loans purchased from Penn Square. Ideally, "accurate and timely disclosure of both favorable and adverse information facilitates the optimum allocation of capital among competing investments and deters risk-taking that is deemed excessive by the suppliers of capital".[53] Disclosure, many agreed, is a good thing. But is it an adequate substitute for direct regulation?

---

[48] Friedman, *op. cit.*, p. 22.

[49] Bank regulators have taken steps to supply additional information on non-performing loans and interest-sensitive assets and liabilities and information on enforcement actions taken against banks. Additional information needed but not yet proposed includes aggregate domestic and foreign loan concentrations by industry sector.

[50] Comments (in March and April 1985) on the FDIC's proposal to disclose the names of banks and bank officers subject to statutory enforcement actions initiated by the FDIC reveal substantial reservations by state bank supervisors toward this particular policy approach. Most of the commissioners took exception to the proposed policy statement and argued that the possible consequences in terms of public confidence could be counterproductive.

In response to a written question from Senate Banking Committee Chairman Jake Garn following the Committee's February 20, 1985 hearing, Federal Reserve Board Chairman Paul Volcker wrote that the Board believed that "routine or across-the-board public disclosure of all regulatory enforcement actions is not desirable . . . ." He added that the Board intended to maintain supervisory discretion in such matters as permitted by the enforcement statutes, noting that the statute recognizes "that public disclosure, under certain circumstances, could do irreparable and unwarranted harm to the bank, frustrate regulatory action designed to rehabilitate the institution and, therefore, may not be in the public interest."

[51] Longstreth, "In Search of a New Financial Safty Net for the Financial Services Industry", *op. cit.*, p. 101.

[52] Though it has, quite appropriately, resulted in "some loss of confidence in the certificates of deposit of some of those banks, and at least one change in rating by a rating agency" (Friedman, *op. cit.*, p. 22) and depressed stock prices for the larger, multinational banks.

[53] Longstreth, "In Search of a New Financial Safety Net for the Financial Services Industry", *op. cit.*, p. 101.

There are good grounds for doubt about its adequacy. First, there is the perception, already discussed, that large banks will not be allowed to fail. This "prevents the marketplace from operating efficiently . . . (because) large bank depositors and creditors [realize] that they would not be required to absorb the full consequences of a bank failure (and this) erodes the incentive necessary to conduct their money management activities in a manner designed to deter the bank from incurring excessive risk." [54] The FDIC hopes to restore this incentive by pressing for risk-related insurance premiums and other changes in insurance coverage that will decrease risk-taking. But this may not persuade all investors that the government will not intervene to prevent failure:

> For many of our larger financial firms, the collateral repercussions of failure would be intolerable. In many cases, the costs of resuscitating a failing firm would be far less than the system-wide costs of letting it go.[55]

Second, there is the question of needs and convenience. As one observer has noted, "there is certainly a positive value in not creating a system in which individual depositors feel they must make an investment decision about their short-term balances." [56] While the continuation of provisions for insurance of deposits up to $100,000 will cover most individuals' short-term balances, the somewhat larger transactions balances of other depositors—including small businesses, small financial institutions, non-profit organizations and state and local government agencies—may not be covered by insurance and these institutional investors may not have the capabilities or resources to conduct meaningful risk analysis of institutions with whom they place their funds. When dealing with so essential a financial service as demand deposits, the free market model tends to ignore the realities of scale. Such a model for containing risk seems more applicable to the cash management division of a mega-corporation than the bookkeeper of a local construction firm, car dealer, or school district. The notion that putting these depositors "on their own", with little assurance that regulators are overseeing the soundness of institutions on which they depend, is not an acceptable solution.

Third, the issue of interdependence and velocity in the movement of funds raises other doubts. How much should a financial institution disclose about its relationships with other financial institutions, the volume of its inter-firm debits and credits, the average level of its cash position, etc.? Such information may be necessary not only to the public but to other financial institutions since they, too, must make risk analyses of the institutions with whom they deal in the absence of direct regulation. But the quantity of information that may be required if risk analysis by investors is used as a substitute for direct examination by regulators could possibly defeat the purpose It would be a burden both to the institution required to supply the information and the analyst who had to digest it.

---

[54] *Ibid.*, p. 102

[55] *Ibid.*, p. 102

[56] Friedman, *op. cit.*, p. 21

Moreover, the timeliness of the information may be an issue. Quarterly reports may not be adequate in situations in which financial conditions can deteriorate very rapidly. Would a quarterly report by Drysdale have made a difference? And the fact that Drysdale, E.S.M. Government Securities Inc., Bevill, Bresler & Schulman Asset Management Corp. and other unregulated securities firms, escaped detection suggests the possibility that still other financial institutions with whom the major institutions routinely deal could slip between the cracks and avoid disclosure.

Finally, there is the issue of failure itself. The market can only, ultimately, exert its discipline if it can *cause* financial institutions to fail. This may mean a gradual erosion of profits and viability as the market forces some institutions to pay more for funds than others. Or it may mean "a run on the bank"—an abrupt loss of confidence in which depositors or investors withdraw funds overnight.

The reality of failure in a deregulated environment is not disputed. Former Comptroller Conover stated that "banks cannot take on increased risk without accepting ultimate responsibility for their mistakes." [57] Former FDIC Chairman William M. Isaac concurred: "Deregulation carries with it greater freedom to make mistakes, and some of those mistakes will no doubt be serious enough to cause failure." [58]

But the consequences of failure have not been incorporated into the theoretical model by these or other advocates of deregulation, as their handling of the Continental Illinois crisis made clear. In particular, they ignored the systemic repercussions that result from interdependence to which former Commissioner Longstreth, President Corrigan, Federal Reserve Board Chairman Volcker and others had called attention. The likelihood that any failure of even moderate size will not spread throughout the financial system is a thing of the past. Commenting on the "Silver Crisis", Chairman Volcker said:

> Some of the institutions with the greatest exposure in the silver situation had farflung activities in many other markets. Had one of those institutions become insolvent, the problem would have quickly spread to other markets, many of which are far removed from silver.[59]

As subsequent problems have demonstrated the prophetic accuracy of Chairman Volcker's remarks on the consequences of financial interdependence, Mr. Longstreth and others have been persuaded that substituting market forces for direct regulation "should give pause to policymakers" because "the collateral consequences of failures often pose unacceptable costs to our financial system".[60] Few are willing to spell out those costs, but some of the flavor of their thinking can be discerned in Chairman Volcker's warning about the dangers posed by the debt problems of developing countries:

---

[57] Remarks of C.T. Conover before the SEC Major Issues Conference, October 7, 1982 (Quoted by Longstreth, "In Search of a New Safety Net for the Financial Services Industry", *op. cit.*, p. 102.)

[58] William M. Isaac, Address to the American Bankers Association, 62 Annual Convention, October 19, 1982.

[59] Statement of Paul A. Volcker, Chairman, Federal Reserve Board of Governors, *Margin requirements for Transactions in Financial Instruments: Hearings on S. 2707* before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, May 29, 1980, p. 5.

[60] Longstreth, "Open Letter—", *op. cit.*, p. 12.

> We are talking about dealing with a threat to the recovery, the jobs, and the prosperity of our own country, a threat essentially without parallel in the postwar period.[61]

REGULATING IN A DEREGULATED ENVIRONMENT

Pressures to end restrictions on the kinds of businesses in which financial institutions may engage result in commensurate pressures on a regulatory framework which assumes a segregation of financial functions and products. Such a system of regulation clearly would be inappropriate to deal with the diversified financial conglomerate. Indeed, many have argued that the existing system is already obsolete; that it results in different regulatory treatment for identical functions and thus causes significant competitive inequities.[62]

To rectify these problems, it has been proposed that a system of functional regulation be adopted. As one observer notes: "The notion of functional regulation suggests that it generally makes sense to have similar functions regulated in the same way by the same regulator."[63] There is "some consensus on the idea"[64] and the "principle sounds impeccable." But, as some have argued, if it sounds simple, it is deceptively so. "The problem lies in defining the function,"[65] since there is "very little idea of what the proper functions are."[66]

Several suggestions for redefining financial functions have been offered. One provides the following outline of definitions: sales, investment management, intermediation, custody of the funds of others, market-making, lending, insurance.[67] But as each function is examined, new problems emerge. It is becoming increasingly difficult to distinguish between "investment products", "deposit products" and "insurance products". For example, how does a jumbo CD differ from commercial paper and how do both differ from other debt issues that are defined as securities? Is a Single Premium Deferred Annuity an insurance product or securities product? Why are options on stock index products and foreign currencies traded as securities on stock exchanges while futures on these products are traded as commodities on commodities exchanges? The differences in regulations that currently apply to options and futures are by no means insignificant, and some—differences in margin requirements, for example—have important implications for risk. Will functional regulation resolve regulatory disparities that result from overlapping products?[68]

---

[61] Statement of Paul A. Volcker, Chairman, Federal Reserve Board of Governors; *International Financial Markets and Related Problems*: Hearings before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, February 2, 1983, Serial No. 98-13, p. 66.

[62] See, for example, the statement of SEC Chairman John S.R. Shad, *The FDIC Securities Proposal and Related Issues*, *op. cit.*, June 16, 1983; p. 42.

[63] Friedman, *op. cit.*, p. 19.

[64] *Ibid.*, p. 2.

[65] Longstreth, "Open Letter—" *op. cit.*, p. 4.

[66] Friedman, *op. cit.*, p. 2.

[67] *Ibid.*, p. 20.

Confronted with the dilemma of product blending on top of functional blending, some proposals for rationalizing the regulatory system suggest that the various regulatory functions be consolidated as well—or at least that the Securities and Exchange Commission and the Commodity Futures Trading Corporation on the one hand, and bank and thrift regulators, on the other, be consolidated into single agencies. But proposals for some degree of consolidation are not new. The consolidation of bank regulatory agencies was suggested by Federal Reserve Board Chairman Marriner S. Eccles to President Roosevelt and described in a chapter in his 1951 memoirs, *Beckoning Frontiers*, entitled "Competition in Laxity".[69] The same recommendation was subsequently offered by the Hoover Commission in the 1950s and the Hunt Commission and FINE Study in the 1970s. Its failure so far to achieve realization suggests that strong interests are at stake.

Those who oppose a consolidation of regulatory agencies and/or functions argue that a multiplicity of regulators at both Federal and State levels has the beneficent effect of breaking up the monolithic power of government; that competition between regulatory authorities encourages flexibility and innovation. But others argue that it may have the opposite result by retarding change in situations where one regulator among many can exercise veto power, and by producing chaos rather than efficiency.[70] Some term the competition between regulators a "race to the bottom" and suggest that it prevails because the institutions like a system that allows them to pit one regulator against another and force a "lowest common denominator" approach. Former FDIC Chairman Isaac "admits that the system exerts a natural pressure on him and his peers to find the level of least resistance." [71]

Thus it would appear that pressure to reorganize the current regulatory framework arises as a result of institutional changes that have already occurred as well as prospective changes, and because of concerns for both competition and soundness. As Chairman Volcker has argued, the inability of the regulatory framework to adapt to the emergence of new structures and products results in consequences that "are obvious and serious":

> In some cases, the services are less readily available, at higher cost than would otherwise be the case. Important competitive inequalities exist, as some institutions are able to take advantage of loopholes or ambiguities in the existing legal fabric and others are not. And in some cases, important objectives of public policy embodied in existing law are threatened or undermined. The pervading atmosphere of unfairness, of constant stretching and testing of the limits of law and regulation and of circumvention of their

---

[68] For further discussion of overlapping products and regulatory disparities, See Part III, Chapter 1.

[69] Richard Whittle, "Foxes Are Guarding the Henhouses . . . Say Critics of Bank Regulatory System", *Congressional Quarterly*, September 10, 1983, p. 1903.

[70] Friedman, *op. cit.*, pp. 11-12.

[71] Whittle, *op. cit.*, p. 1903.

intent, and of regulatory disarray is inherently troublesome and basically unhealthy.[72]

Many of the problems that Chairman Volcker describes might be resolved by consolidating regulatory agencies and implementing a system of functional regulation—the two proposals put forward so far. Both of these proposals, however, tend to look backward, past the blurred image in the foreground to the clearer structure that once lay behind. They fail to take account of the expanding role of the securities markets[73] and of trading activity as an increasingly dominant component of financial transactions. And they ignore the implications for regulation of the new structure that is emerging as the diversified financial conglomerate becomes the construct of financial consolidation.

The rise in trading activity in unstructured markets[74] for government securities, commercial paper, certificates of deposit, mortgage-backed securities and foreign exchange, and the proliferation of participants in these markets—depository institutions, securities firms, insurance companies, money managers and other financial and nonfinancial companies—suggests the need to focus on the *kind* of regulation that will be appropriate for a financial system in which distinctions between lending and investing are already blurred, rather than the way regulation is packaged. As discussed in Part I, Chapter 3, advances in telecommunications technology have already created new opportunities for improving the effectiveness of regulation through monitoring and surveillance of activities in structured markets. From a regulatory perspective, a more appropriate emphasis in financial restructuring would be to focus on surveillance and on restructuring markets rather than institutions.

In addition, regulators need to focus on the fact that, obviously, consolidating financial functions and products creates a new paradigm for corporate strategy. If the intracompany linkages and transactions that constitute the efficiency-producing synergisms of a diversified financial holding company are to occur—and why, if they are not to occur, would diversification be desirable?[75]—how can they be monitored? In a diversified financial conglomerate with insurance, mortgage banking and finance company affiliates regulated by 50 state regulators and depository and securities affiliates by Federal and state regulators, which regulator will assume responsibility for monitoring the relationships and transactions among them? Can such a diversified regulatory structure assure that conflicts of interest (which, as historical evidence suggests, do cause losses and undermine soundness) do not become a habitual and accepted form of business practice that subordinates fiduciary responsibility to the imperatives of efficiency and market survival?

---

[72] Statement by Paul A. Volcker, Chairman, Federal Reserve Board of Governors, *Moratorium Legislation and Financial Institution Deregulation: Hearings on S. 1532, S. 1609, and S. 1682* before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 98th Cong., 1st Sess., September 13, 1983, Serial No. 98-422, p. 2.

[73] See Part II, Chapter 4.

[74] Unstructured markets are those that are not centralized around systems that provide information on prices and trading volume. Stock exchanges are centralized markets and the U.S. over-the-counter market, once an unstructured market, has been centralized to a great extent, with trading conducted and price information disseminated electronically through the National Association of Securities Dealers Automated Quotations System (NASDAQ) rather than on the floor of an exchange.

[75] "Synergy" is used to express the expectation that combining financial functions will generate new businesses and larger profits than separate functions could develop alone. For evidence that synergies realized thus far have been limited, however, see David B. Hilder and Steve Weiner, "Difficult Fits: Big Brokerage Houses are Problem Children for their New Parents", *The Wall Street Journal*, September 13, 1985, p. 1.

The usual response to such questions from those who reject the notion that deregulation is a goal in itself by those who believe it is, is a call for increased disclosure. Disclosure is a powerful regulatory tool but it, too, must be policed by the regulators, the institutions performing underwriting services, and the market. Leaving aside the problem of the regulators raised above, there are equally valid questions about the ability of underwriters to meet their obligation to assure that all material facts in the case of a financial conglomerate are known by the public that buys its securities. Since many underwriters are themselves part of a diversified financial conglomerate, the close scrutiny required to assess the possibility of self-dealing by a competitor would be inappropriate.[76]

But the more important question is: who constitutes the market? Is it millions of small individual investors who must accept the additional burden of assessing information on intracompany transactions that may or may not constitute conflicts of interest that, in turn, may or may not undermine soundness? Or is it institutional investors that may, themselves, be part of a diversified financial corporation, involved in similar transactions, whose perceptions of risk may be blunted by self-interest?

Meanwhile, there are already indications that deregulation is straining the capacity of regulators to do their job, even as currently defined. Issues of competence, the level of salaries and the rapid turnover of staff are raised with increasing frequency.[77] Thus, the use of the term "deregulation" appears increasingly to be a misnomer. In the context of the current debate, the objective of deregulation—to permit all financial institutions to engage in any activity of a financial nature and, as some propose, to combine these financial activities with commercial activities—can only lead to more, not less, regulation.

---

[76] The inadequacy of existing rules governing conflicts of interest promulgated by self-regulatory organizations in the securities industry and other issues raised here are discussed in Part II, Chapter 3.

[77] Dr. Henry Kaufman, testifying before the Subcommittee on Telecommunications, Consumer Protection and Finance, proposed upgrading the supervisory agencies by raising standards and salaries to attract better qualified people. He stressed the significance of the supervisors' responsibility, adding: "It is unfortunate that the emphasis on monetarism and deregulation relegated supervisory agencies to a second and third level of importance." (Dr. Henry Kaufman, Executive Director, Salomon Brothers, Inc., *Financial Restructuring and Takeover Activity: The Major Policy Issues*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, June 5, 1985, Serial No. 99-21, p. 395.

Attention was given to the serious erosion in the quality of bank examination on the Federal and State levels in two *Wall Street Journal* articles. Regulators themselves admitted being overwhelmed by their ever-growing responsibility for detecting risks in the banking system. As a national bank examiner for 24 years lamented, "The banker is always ahead of the examiner." The ranks of Federal bank examiners are dwindling, and even worse, their competence and ability to catch problems is declining, one article reported (Monica Langley, "Federal Bank Examiners Are Drawing Fire", *The Wall Street Journal*, July 16, 1985, p. 6). As a result, some Federal agencies are seeking to transfer part of their supervisory workload to the states, which are, however, even less equipped to do an adequate job. The extremely high turnover suffered by state regulatory agencies is due to the grueling travel schedules and low salaries. Expertise required to master the complexities of modern banking is lacking and poor communications and turf battles with Federal agencies exacerbate the problem (John Bussey and Clare Ansberry, "Ailing Watchdogs—State Bank Examiners Often Lack Numbers and Skill to Do Work", *The Wall Street Journal*, July 16, 1985, p. 1).

H.R. 3567 was introduced by Members of the House Committee on Banking, Finance and Urban Affairs on October 16, 1985 to ensure that there are an adequate number of highly qualified Federal examiners to evaluate our nation's depository institutions so as to provide for their safety and soundness.

MANAGING LIQUIDITY

The extent to which interest rate deregulation enhances the potential for liquidity problems is exemplified by the Continental Illinois crisis. The link between that crisis and interest rate deregulation has, however, been ignored. It is frequently argued that Continental Illinois' problems were in no way related to "deregulation"[78]—that bad loans and bad management, the traditional problem areas for banks, were responsible for this big bank's near-failure—and that the liquidity crisis it suffered was caused by outmoded state restrictions on branching that limited the amount of small (and, therefore, insured) time and demand deposits it could attract.

This argument overlooks the fact that over half of the deposits of large banks had not been subject to interest rate ceilings for more than a decade before the Continental Illinois crisis. Interest rate deregulation began with the decision not to extend interest rate ceilings to Eurodollar deposits in the 1960s and the removal of interest ceilings on large, negotiable domestic certificates of deposit in 1970 in response to banks' strategies of importing Eurodollars to offset run-offs of low-interest, domestic deposits in periods of rising interest rates. Purchases and sales of federal funds and repurchase agreements also were not subject to interest rate ceilings. As a result, large banks could better survive the rigors of disintermediation than small banks and thrifts. But the competition for funds between large banks and other intermediaries at the peak of the business cycle tended to drive interest rate levels ever higher as the decade progressed, and eventually forced the abandonment of virtually all interest rate ceilings.

It is true that state branching laws restricted the amount of retail deposits that Continental Illinois and other large Illinois banks could attract. Had they not had alternative sources of funds, their growth potential and ability to compete with other money center banks could have been seriously undermined. However, their ability to tap domestic and international money markets may have obviated their need to press for more liberal state branching laws—the more so since other money center banks were also moving away from primary reliance on retail deposits.

But the implications of increased dependence on uninsured, interest-sensitive funds by Continental Illinois and other large banks went unnoticed by regulators. Even without problem loans, other factors—for example, interest rate shocks or a crisis of confidence originating in another institution at home or abroad—makes any such bank more vulnerable to a liquidity crisis.

Actions to end interest rate regulation in 1980 were intended to resolve the problem of disintermediation and assure that market rates of interest were available to small savers as well as large investors. What was not foreseen was the extent to which interest rate deregulation might erode the stability of banks' deposit base. Now, however, the threat to liquidity posed by purchased funds is more visible as a result of the wide-spread use of brokered deposits by even small institutions.

---

[78] Meaning, in this context, expanded powers. However, as noted in footnote 28 above, the expansion of Continental Illinois' nonbanking affiliates eroded its capital position and ultimately affected the profitability of the bank.

Clearly a bank like Continental Illinois—or any bank with more uninsured than insured deposits—must be managed with a focus on liquidity as well as solvency. Managing liquidity requires close attention to matching the maturity of assets and liabilities. The traditional role of banks in intermediation—the use of short-term deposits to fund longer-term loans—cannot be undertaken with any degree of safety in the absence of a strong base of core deposits held by customers whose incentive to withdraw funds has been reduced by the guaranty of insurance. The experience with Continental Illinois illustrates the problem. As the bank liquidated assets in the wake of deposit withdrawals, it was evident that the supply of short-term loans and readily-marketable investments was inadequate. Even as Continental Illinois shrank from $40 billion to $25 billion in asset size, it still required large infusions of funds from the Fed, the FDIC, and from other banks organized to provide support.

For most large money center and multinational banks, liquidity management is now (and will continue to be) a key factor in survival. And, as a result of interest rate deregulation, smaller banks and thrifts also must pay attention to their liquidity positions. But matching maturities of assets and liabilities will constrain their ability to intermediate between the short-term preferences of depositors and the longer-term preferences of borrowers. Leaving aside the impact this may have on the economy, it is also likely to reduce profits. Therefore, it is unlikely that banks will adopt this approach. As recent innovations involving securitized credit suggest, they are more likely to de-emphasize their role as portfolio lenders.

What they have done so far is attempt to minimize interest rate sensitivity. Banks have responded to interest rate deregulation by shifting from fixed to variable rates in pricing loans. Although variable rate loans have become more visible in the domestic market only recently as a result of their extension to residential mortgages, they are not new. A near-decade of experience in pricing foreign loans suggests, however, that variable rates do not reduce liquidity risks for banks that rely heavily on money markets for funding.

Some would argue that regulators must take responsibility for devising new strategies for managing liquidity. Few industrial countries regulate interest rates or have as extensive deposit insurance programs as does the United States. But most have liquidity requirements.[79] As other traditional tools of U.S. bank regulation are removed or weakened, liquidity requirements may assume greater importance as a strategy in U.S. soundness regulation.

---

[79] Many industrial countries require that medium- and long-term loans be funded by deposits of the same maturity. While the success of one major U.S. bank in circumventing the liquidity requirements of foreign countries indicates that they can be avoided easily by using interbranch transactions (see *SEC and Citicorp, op. cit.*, pp. 812-833), concerted actions by U.S. and foreign regulators could make such requirements more effective.

Meanwhile, U.S. regulators have required banks to raise the ratio of capital to assets and are proposing that contingent liabilities be backed by capital. Some propose including long-term subordinated debt in significantly higher capital ratios. One effect of these efforts is to lengthen the average maturity of total liabilities. But pressure to add liquidity on the liability side tends to constrain liquidity on the asset side of the balance sheet. Banks responded by reducing their interbank placements in the Euromarkets—an important source of liquidity even if one that increases interdependence and enhances their vulnerability to systemic problems. As a result, the ratio of loans to total assets rose significantly.[80] As noted, one bank responded to this new constraint on overall liquidity by securitizing a substantial portion of its loan portfolio;[81] another by selling loans to a newly-created entity that funded the transfers by issuing commercial paper. The limited value of this latter strategy as a means of protecting the bank[82] underscores the need for more balanced solutions to promote liquidity.

Changes in strategies for managing liquidity

Shifts in banks' liquidity strategies over the last two decades have rarely been questioned by markets or regulators. Since the 1960s, banks have increasingly relied on borrowings from other banks to adjust their positions. But heavy reliance on the interbank market for systemic liquidity is inherently risky. Obviously, one bank's asset is another bank's liability. Therefore, the interbank market is a highly efficient system for distributing liquidity in an expanding market. When funds are entering the banking system from outside sources, interbank placements help move these funds very quickly to ultimate borrowers while rewarding banks that participate in the gathering and distributing process with a small margin of profit. But the interbank market aggravates the problem of maintaining systemic liquidity in a contracting market. If there is a significant withdrawal of funds from the banking system by nonbank depositors, the rush by banks to withdraw interbank placements to meet nonbank deposit run-offs amplifies the amount of deposits lost by individual banks and the system as a whole.

The use of interbank placements as a source of liquidity is not new nor are its risks hypothetical. Before the establishment of the Federal Reserve System in 1914, banks held the majority of their reserves as correspondent balances with other banks. Reserves tended to concentrate in the larger city banks, primarily in New York, where they were invested in call loans to brokers. In 1907, losses in the stock market wiped out a substantial share of bank reserves and resulted in a widening circle of bank failures. Following extensive Congressional hearings and outside discussions, a consensus emerged concerning the need for a new system to safeguard bank reserves and for a role for government in providing liquidity to the banking system.[83]

---

[80] See, for example *A Review of Bank Performance: 1984 Edition*, Salomon Brothers Inc., New York, NY, 1984, p. 60.

[81] Robert A. Bennett, "Sanford's New Banking Vision", *The New York Times*, March 17, 1985, p. F1.

[82] It is a strategy that merely shifts the maturity mismatch from the bank to a holding company-related entity while continuing to rely on interest-sensitive, short-term purchased funds.

After the creation of the twelve regional Federal Reserve banks, the banking system continued to rely on call loans as a back-up source of liquidity. Although government borrowing to finance World War I resulted in a dramatic increase in outstanding issues of Treasury securities (from $1 billion to $25 billion), these assets could not be used as collateral for currency and banks were discouraged from holding them. After the collapse of the stock market in 1929, however, many banks were found to have large holdings of Treasury securities. Some had been purchased because banks believed they were a safe investment for depositors' funds. Others were acquired because they had been pledged as collateral for loans on which borrowers defaulted. But the build-up in banks' holdings of governments hampered the Federal Reserve's efforts to provide liquidity to the banking system, and thus the ability of banks to provide liquidity to other sectors, because these assets could not be used as the basis for money creation. As more and more banks collapsed and the problem became more evident, emergency legislation was passed authorizing the use of Treasury securities as backing for Federal Reserve notes.[84]

The 1932 emergency legislation—renewed periodically until it became permanent after World War II—enhanced the role of Federal Reserve open market operations in government securities as a monetary tool and altered banks' strategies for managing liquidity. After the Depression and through most of the 1960s, banks relied heavily on purchases and sales of Treasuries to adjust their liquidity positions. During this period, Treasuries were the dominant money market instruments used by investors as substitutes for bank deposits. When nonbank depositors shifted funds out of the banking system in a period of rising interest rates, they bought Treasuries. Most of the demand for Treasuries was met by banks. Their sales of Treasuries resulted in a symmetrical reduction in both sides of their balance sheets. Thus, disintermediation—outflows of funds from banks when market rates rose above interest ceilings on bank deposits—was a more tolerable consequence of interest rate regulation when banks relied on investments in government securities to manage their liquidity positions. And, of course, individual banks could more readily meet a liquidity crisis without transmitting their problems to other banks.

As this brief historical discussion suggests, managing liquidity may require new monetary and portfolio strategies that are more responsive to current market conditions. Because banks play a key role in supplying liquidity to other financial and nonfinancial sectors, economic stability depends on their ability to manage their own liquidity positions. Meanwhile, further efforts to deregulate the banking system may make efforts to devise new strategies for managing liquidity more difficult. Dr. Henry Kaufman has observed that the optimal period for deregulating the banking system was immediately after World War II.[85] Banks' capital ratios were high (about 10 percent on average) as were their holdings of government securities. Absorbing the impact of interest rate deregulation in a period when both capital ratios and holdings of nonbank liquid assets were at historically low levels has greatly increased the fragility of the banking system.

---

[83] *Federal Reserve Structure and the Development of Monetary Policy: 1915-1935*, Staff Report, Subcommittee on Domestic Finance, Committee on Banking and Currency, U.S. House of Representatives, 92nd Congress, 1st Session, December 1971; pp. 14-15.

[84] *Ibid.*, pp. 26-27; 142-143.

Many witnesses who have testified before congressional committees have argued that further deregulation should not be authorized until depository institutions have adjusted to interest rate deregulation. Few, however, have offered proposals for regulatory strategies to assist banks in meeting the challenges posed by interest rate deregulation. The magnitude of the liquidity crisis experienced by Continental Illinois suggests, however, that Congress should evaluate the need for changes in regulatory strategies as well as proposals to shift regulatory responsibilities.

A SUMMARY OF POLICY CONCERNS

As a number of statements by Chairman Volcker and others imply, the framework for financial structure and regulation has been impaired. There has been an erosion of both the fairness of competition and of soundness compared with the past. But criticisms of proposals to revamp "the way the government organizes itself to regulate financial institutions and the regulatory ground rules themselves—the major structural decisions made by Congress in the 1930s about the nature of financial institutions and the architecture of financial markets," [86] are too numerous and valid to be dismissed.

The 1983 Treasury proposal illuminates the underlying objective of those who favor deregulation: to develop a new structure in which, over time, financial institutions will be able to conduct any business "of a financial nature". At least one critic of this proposal has publicly questioned its basic assumption:

> I know of no immutable principle or received wisdom, holding that entry into *all* aspects of the financial services industry must be accorded to every financial intermediary, whether in the name of competition, fairness, efficiency or whatever.[87]

Some have also questioned the assumption that it is the market that has created the pressure for deregulation,[88] and question whether deregulation and a freer play of market forces can resolve the inherent conflicts between increasing competition and maintaining soundness:

---

[85] Dr. Kaufman made this observation in a discussion with Representative Timothy E. Wirth in December, 1984.

[86] Friedman, *op. cit.*, p. 2.

[87] Longstreth, "Open Letter—" *op. cit.*, p. 11.

[88] In urging a reexamination of the existing legislative framework, Chairman Volcker stated that, "left unattended, we can continue to see the financial system evolve in haphazard and potentially dangerous ways—ways dictated not just by natural responses to market needs but by the often capricious effects of existing and outmoded provisions of law" (Statement to the Senate Banking Committee, *Moratorium Legislation and Financial Institutions Deregulation, op. cit.*, September 13, 1983, p. 2).

> We normally should and do look toward the marketplace—free of regulations except those necessary to preserve competition—to promote competition and efficiency. But when soundness, confidence, and continuity in the provision of money and payments services are at stake, deregulation cannot *alone* achieve the objectives because some degree of government support and regulation is implicit. The creation of the Federal Reserve and the FDIC—and, more recently, our shared concern about the need for more intensified supervision of international lending—are obvious cases in point.[89]

These critics are in search of "some measures beyond additional disclosure requirements",[90] some means of retaining "essential safeguards—including an adequate supervisory framework." [91] Most agree that a new system is needed and that it should incorporate provisions for *direct* regulation as well as permit market forces "to do their share of the job." [92] It has been suggested that this new regulatory system must be flexible enough "to adapt to changes in the regulated industry without distorting the regulatory system or the industry." [93] It must "avoid damaging the Federal Reserve's ability to implement monetary policy" [94] and assure the impartiality of the credit decisionmaking process.[95] Above all, it must meet the ultimate test of the government's responsibility for soundness: the provision of a rational safety net "that can avert or arrest a pending financial crisis." [96]

It is perhaps the adequacy of the existing "safety net" that constitutes the most pressing public policy concern in the current debate. The mounting number and frequency of financial crises over the last decade, the rapidity with which the problems of a single institution can be transmitted to others and the growing perception of the economic and social costs of financial failures underscore the need to address this issue. While some specific suggestions have been made,[97] little discussion—let alone a thorough exploration—of the issue has been undertaken.

---

[89] *Ibid.*, p. 5.

[90] Office of the General Counsel, Securities and Exchange Commission, Answers to Questions Submitted by Chairman Wirth, *The FDIC Securities Proposal and Related Issues, op. cit.*, June 16, 1983, p. 130.

[91] Volcker Statement, *Moratorium Legislation and Financial Institutions Deregulation, op. cit.*, September 13, 1983, p. 7.

[92] Longstreth, "Open Letter—", *op. cit.*, p. 12.

[93] Friedman, *op. cit.*, p. 18.

[94] *Ibid.*, pp. 17-18.

[95] Corrigan, "Are Banks Special?", *op. cit.*, p. 17.

[96] Longstreth, Answers to Questions Submitted by Chairman Wirth, *FDIC Securities Proposal and Related Issues, op. cit.*, p. 130.

[97] In his answers to questions submitted by Chairman Wirth (*The FDIC Proposal and Related Securities Issues, op. cit.*, p. 130), Commissioner Longstreth describes how the financial "safety net" functions, "either by injecting liquidity into the financial system or by extending credit directly to troubled institutions", and suggests ways that the existing system can be improved to meet current needs:

> The existing insurance funds, of course, protect up to a prescribed limit the deposits or securities in the possession of a financial institution that fails. In addition, the bank regulatory agencies have the power to extend credit to financial institutions experiencing financial difficulties and to facilitate the merger of a failing institution into a healthy institution. Finally, the Federal Reserve Board has the ability to create liquidity in the financial marketplace through its open market operations. We should examine, however, whether the present capacity is adequate. For example, SIPC has no alter-

Continued

So far, the threat of a major systemic crisis has been contained. Some would argue that containment has been the result of the skill and dedication of individual regulators. Others say that it was merely good luck. For example, the Fed persuaded Chase Manhattan to absorb a substantial portion of Drysdale's losses on the grounds that it had acted as agent for the government securities dealer. Had the Drysdale default occurred after the failure of Penn Square Bank and the Mexican crisis, Chase might not have been able to absorb these losses without seriously undermining public confidence in the bank. Similarly, in the Continental Illinois crisis, the Fed and FDIC persuaded some 20 or more large banks to continue to supply funds to Continental. If other large banks had been facing liquidity problems at the same time, it would have been more difficult for the Fed and FDIC to replace funds lost through withdrawals and prevent a systemic crisis.

In summary, the financial system is inherently fragile. The government's responsibility to intervene to protect the system has been recognized since the Federal Reserve Act was passed 70 years ago. Deregulatory initiatives that ignore that responsibility and undermine regulators' ability to ensure the stability of financial markets propose an abdication of a role that historically has been closely linked to the Constitutional responsibility of Congress to regulate the value of the national currency.

---

native other than to preside over the liquidation of a failed brokerage firm; it has no authority to extend credit or facilitate mergers. Perhaps there continues to be a sound public policy for treating securities firms differently from depository institutions. But this issue should be explored. Another area which should be considered is the authority of the Federal Reserve Board to extend credit to financial institutions other than banks. Under present law the FRB can extend emergency credit to non-banks only in "unusual or exigent" circumstances. As a practical matter, this power cannot be effectively exercised. Consideration should be given to expanding the scope and flexibility of the FRB's emergency lending authority to encompass all financial institutions. Study of the subject would no doubt reveal other areas needing to be improved.

CHAPTER 3: PROMOTING COMPETITION AND THE IMPARTIALITY OF CREDIT DECISIONS

INTRODUCTION: SPECIALIZATION AND DIVERSITY VERSUS CONSOLIDATION

Market participants and analysts take pride in the sophistication, breadth and depth of U.S. capital and credit markets. No other national market offers so extensive a "menu" of financial assets and none have such well developed and liquid secondary markets. The efficiency, ease and relatively low cost of transactions, coupled with U.S. political stability and the strength of the U.S. economy, are important factors in attracting foreign investors.

The variety of instruments and opportunities open to investors and borrowers has as its counterpart the multiplicity of institutions that serve as intermediaries in U.S. financial markets. Compared with other countries, the United States has an extraordinary number of financial institutions relative to population, and a wider range of financial sectors offering highly specialized services.

As discussed, the American emphasis on diversity reflects the adoption and expansion of the English model of financial structure. The German model reflects a greater emphasis on consolidation. While consolidation provides significant benefits for financial institutions themselves and for some economic sectors, it appears to have stunted the growth of individual market sectors—in Germany itself, for example, securities markets and consumer credit—and may require that the central bank take a more active role in stabilizing the system and providing liquidity. Consolidation has also tended to reduce the number of institutions within the financial system in countries that have favored that model of organization.

Diversity and multiplicity are stabilizing forces. A greater number of independent decision-makers ensures that those speculative activities which are necessary to markets will have an equilibrating function rather than develop into "bandwagon effects" that produce panics. Diversity and multiplicity also help stabilize the financial system itself because they tend to insulate the system as a whole from the problems and mistakes of individual financial sectors as well as those of individual institutions. And, by offering alternative sources of capital and credit to borrowers, diversity also helps stabilize the economy and promote economic activity.

The argument for retaining a substantial degree of specialization in the financial services industry is based on the concern that a consolidation of financial services will tend to increase the concentration of financial resources and the potential for conflicts of interest, and that this will, in turn, undermine the fairness of access to credit by distorting the impartiality of institutions' credit and investment decisions.

Until recently each major field of the financial industry—banks, thrifts, securities firms, and insurance companies—was almost entirely specialized to itself and supervised mainly by its own regulatory agency. This segregated structure and the specialization it produces has acted as a powerful force for promoting impartiality in credit decisions. For example, if banks are prohibited from engaging in nonbanking or commercial activities, their credit decisions are more likely to reflect an interest in maintaining the profitability of banking operations. If they are engaged in other functions, their lending decisions may be biased or may not be as focused on assuring the viability of specialized banking functions. Even if lending to their own affiliates is restricted, banks may be less likely to lend to competitors of their affiliates. Because banks provide short- and medium-term credit to all economic sectors and other financial institutions, they play a critical role in providing liquidity to the financial system and the economy as a whole. Thus, any impairment of their impartiality could undermine financial and economic stability.

Securities firms and insurance companies also have unique economic functions that require impartiality in the decision-making process. Securities firms act as impartial middlemen between issuers and investors. Their impartiality is critical in promoting confidence in securities markets and may be compromised if—as a result of involvement in activities other than traditional broker-dealer and underwriting functions—they, themselves, become issuers or investors, or affiliates of issuers or investors.

Impartiality is no less a critical factor in assuring that insurance companies perform their economic function in assuming risk for all sectors and that their investment decisions are made in the interest of their fiduciary responsibility. Involvement in commercial or financial activities other than insurance may distort their impartiality both as insurers and investors.

Chart A illustrates the current structure of the financial system and the markets that system serves. For the most part, the major sectors of the financial services industry are still dominated by specialized, independent institutions (property-casualty insurers are the exception), with national markets served by large institutions and a competitive fringe of smaller, regional and local firms.

However, as discussed in Part I,[1] large financial institutions in each of the major sectors have steadily increased their participation in other financial activities (described at the bottom of Chart B), and have gained market power as a result of the growth in pension fund assets which they manage. Moreover, the largest financial institutions are gaining footholds in major financial sectors outside their area of specialization at the same time that large nonfinancial firms are becoming important providers of financial services.

Many observers have viewed this trend toward diversification on the part of large financial and nonfinancial institutions as a movement toward nationwide financial conglomerates. As Chart B suggests, that movement is well underway. While by no means all inclusive, it shows the range of financial services provided by individual conglomerates, and the similarities in services provided by firms whose principal business differs. If this trend toward consolidating financial services within a single holding company structure continues, many believe it could mean a much more concentrated group of financial conglomerates, with substantially weaker competition from smaller, independent regional and local institutions.

---

[1] See Part I, Chapter 2.

CHART A: ESTABLISHED MARKET PARTICIPATION AMONG FINANCIAL INSTITUTIONS

INSTITUTIONAL STRUCTURES	MARKET STRUCTURES
I. Depository Institutions a. Commercial Banks	National market dominated by large institutions serving large customers; regional and local markets with medium-size and small institutions serving medium-size and small businesses, state and local governments and individuals.
b. Thrifts (savings and loan assns and mutual savings banks)	Primarily state and local markets; emerging competitive alternative to commercial banks with special role in housing finance.
c. Credit Unions	Limited market for consumer lending (mostly for employee members); emerging competition for banks and thrifts.
II. Securities Marketing Inst. a. Brokerage Firms b. Mutual Funds & Investment Co's. c. Underwriters	National market dominated by limited number of nation-wide firms with competitive fringe of smaller regional and local firms.
III. Insurance Companies a. Life, Health Insurers	National market dominated by nation-wide firms with competitive fringe of smaller regional and local firms.
b. Property, Liability Insurers	National market dominated by nation-wide integrated firms with competitive fringe of independent and smaller regional and local firms.
IV. Pension Fund Managers a. Commercial Banks b. Insurance Companies c. Securities Firms & Other Managers d. Labor or Professional Organizations	National market dominated by large institutions with competitive fringe of smaller regional and local firms.
V. Other (credit card issuers, commercial and consumer financing, mortgage banking, leasing, factoring, trust services, venture capital services, travelers' checks and money orders).	National market dominated by large institutions with competitive fringe of smaller regional and local firms.

Sources: Adapted from William A. Lovett, Banking and Financial Institutions Law, October, 1980, p.305.

Chart B
Selected Diversified Financial Conglomerates

FIRM -(Principal Business)	INSURANCE	REAL ESTATE	SECURITIES	DEPOSITORY INST.	OTHER FINANCIAL*
Aetna Life & Casualty (Insurance)	$	$			$
American Can Company (Manufacturing)	$	$	$	$	$
American Express Co. (Diversified Financial)	$		$	$	$
American General Corp. (Diversified Financial)	$	$	$		$
Armco Inc. (Steel)	$	$			$
Avco Corp. (Defense Contracting)	$			$	$
BankAmerica Corp. (Banking)	$	$	$	$	$
Beneficial Corp. (Consumer Finance)	$			$	$
Borg Warner Corp. (Manufacturing)	$		$		$
Chrysler Corp. (Manufacturing)	$	$			$
Citicorp (Banking)	$	$	$	$	$
Control Data Corp. (Computers)	$			$	$
Equitable Life Assurance Society of the U.S. (Insurance)	$	$	$		$
Ford Motor Company (Manufacturing)	$	$		$	$
General Electric (Manufacturing)	$	$	$		$
General Motors Corp. (Manufacturing)	$	$			$

FIRM -(Principal Business)	INSURANCE	REAL ESTATE	SECURITIES	DEPOSITORY INST.	OTHER FINANCIAL*
Greyhound Corp. (Transportation)	$				$
Gulf & Western Industries Inc. (Commercial Conglomerate)	$	$		$	$
Household International Corp. (Consumer Finance)	$			$	$
ITT (Commercial Congl)	$		$		$
Merrill Lynch Co. (Securities)	$	$	$	$	$
National Steel Corp. (Steel)		$		$	$
Parker Pen Company (Manufacturing)	$			$	$
J.C. Penny Company (Retail)	$	$		$	$
Prudential Insurance Company of America (Insurance)	$	$	$	$	$
RCA Corp. (Electron.)	$				$
Sears Roebuck & Co. (Retail)	$	$	$	$	$
Transamerica Corp. (Insurance)	$	$			$
Westinghouse Electric Company (Manufacturing)		$			$

* Other includes: credit cards, consumer lending, financing, leasing, factoring, investment advisory services, mutual fund management, data processing services, purchasing of installment contracts, trust services, venture capital services, merchant banking, pension fund management, travellers' checks and money orders.

Sources: Adapted from Robert E. Litan, "Measuring and Controlling the Risks of Financial Product Deregulation," Brookings Institution, (manuscript in progress), May 30, 1985, p. 63a, and from Dun's Business Month, April 1983, pp. 46-47.

Whether or not this concern is justified, existing barriers to concentration are falling while consolidation is increasing opportunities for cross-marketing products and services. As the discussion in this chapter suggests, the trend toward consolidating financial functions may threaten diversity for several reasons:

By expanding opportunities for self-dealing and reducing the number of independent decisionmakers in the financial system, consolidation may impair the impartiality of credit decisions and the arms-length evaluation of different components of a financial transaction that have characterized our segregated system.

It could result in tie-ins that reduce credit choices for borrowers.

Consolidating financial functions could impair the normal role of banks in providing liquidity to other financial institutions and their special role as a channel for back-up sources of liquidity provided by the central bank in periods of economic and financial stress.

Because many of the new activities of individual institutions will be undertaken through mergers and acquisitions of existing institutions, consolidation could increase the concentration of financial resources.[2]

These developments may, in turn, reduce the multiplicity of credit opportunities, undermine stability in the financial system and the economy as a whole, and increase the social costs of financial failures.

CONSOLIDATION AS AN IMPEDIMENT TO IMPARTIALITY

Most of the current debate on the issues of concentration, conflicts of interest and tie-ins has tended to focus on their anti-competitive implications. However, as discussed above,[3] access to capital and credit has been a recurrent theme associated with these issues in the past and a major influence underlying regulatory strategies designed to assure the impartiality of financial institutions' credit and investment decisions. Because those strategies were embedded in a structural framework that segregated financial functions and markets, the trend toward consolidation is now being perceived as one that may pose a threat to impartiality as illustrated in the following exchange between Subcommittee Chairman Wirth and Federal Reserve Board Chairman Volcker in April, 1984, in the context of a discussion of the Garn Bill (S.2181): [4]

---

[2] An alternative view—stressing the benefits of consolidation—was offered by Stephen J. Friedman in a letter to the Subcommittee, June 5, 1985:

> I do not understand why an institution which can offer only one product is more unbiased than an institution that can offer the whole range. If a bank can only offer loans, the advice one is likely to get is to borrow money. If the same bank could do loans and public distributions of bonds and equity, it would have less of a financial incentive to recommend increased bank lending.
>
> As for tying problems, I am quite impressed with the degree of competition among major banks, at least in New York, and the ability of our financial system to innovate new products when consumer needs are not satisfied.

Another view was presented in testimony before the Subcommittee by Federal Reserve Board Governor J. Charles Partee:

> Concern over conflicts of interest is not limited to issues of separating banking and commerce. It also relates to potential conflicts of interest that may arise from combinations of financial firms and from the diversity of activities allowed within the bank itself . . .
>
> • • • • •
>
> The marketplace is clearly evolving toward ever-broadening combinations of financial services, and there may well be economies, as well as the convenience and other benefits of increased competition, to be gained. In each instance of broader corporate powers, whether in banking, insurance, securities or real estate development, we would urge that these potential benefits be compared with the probable costs, taking into account whether and what workable safeguards against injurious potential conflicts need to be improved.

(Statement of Governor Partee, *Financial Consolidation: The Emerging Regulatory Issues*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance of the Energy and Commerce Committee, U.S. House of Representatives, April 2, 1985, Serial No. 99-21, pp. 22 and 29.

> Mr. Wirth. I'd like you for a few minutes, if you would, to focus on whether instead of simply thinking about deregulating the banks, perhaps we should be looking more carefully at the way in which we are regulating the overall financial industry.
>
> Mr. Volcker. I agree with that. There are two answers to the situation you have proposed; give the banks more power or keep others out of the banking business. That's what this is all about.
>
> Mr. Wirth. That's what we are trying to sort through because we have that very specific jurisdiction relating to the securities industry. And you say that a lot of this has been studied. I'm not sure that it has. A lot of this is very, very new.
>
> Let's take Sears as an example of what is new, and what I don't think has been looked at. If we were to go into Sears to buy a hammer, as opposed to going to the Pentagon to buy that hammer, we go to Sears. We might also be in the market to buy, say a new house. And sitting there right next to the hammer counter is Coldwell Banker, a subsidiary of Sears. So we might decide to stop by there and buy a house.
>
> We need a mortgage loan for that house and Sears also owns an S&L, so the broker for Coldwell Banker refers us over to the next step where we take out a mortgage loan. And Sears, the retailer, may even give me a discount on the washing machine and the furniture for my house so I am really getting more and more involved in Sears. I need insurance so I go to Allstate where I get insurance on the house, the car, and life insurance.
>
> The Sears' S&L, in the meantime, decides that it doesn't want to hold onto my mortgage, so it takes the next step and sells it to Sears. Right? Sears pools a number of the mortgages that it has bought and issues securities which are backed by that pool of mortgages. And who will underwrite those? Guess who. Dean Witter. Right?
>
> Mr. Volcker. Right.
>
> Mr. Wirth. Dean Witter is another subsidiary of Sears. And two months later, when I'm back at Sears buying an-

---

[3] See Part II, Chapter 1.

[4] See also the excerpt from an article by E. Gerald Corrigan at footnote 9 below.

> other hammer, I see the Dean Witter desk, and the friendly broker there sells me mortgage-backed securities and I buy back my own mortgage.
>
> Mr. VOLCKER. That depends upon whether the securities you bought went up or down, I suppose.
>
> Mr. WIRTH. It seems to me that if the nonbank loophole isn't closed, Sears is going to be opening up a number of nonbank banks, accepting deposits and making loans. So, if I could keep a NOW account at Sears, I could also take out a loan on my son's college tuition. Right?
>
> Mr. VOLCKER. Right.
>
> Mr. WIRTH. So, where does that lead us all?
>
> Mr. VOLCKER. We want to clarify that and sort some of that out, and that's why I think this legislation is urgent. We don't want Sears Roebuck in the banking business, and, I think it's fair to say, we don't want them in a general purpose thrift business operating in tandem in the manner that you described, with their commercial business, with their underwriting business, with their insurance business.
>
> * * * * *
>
> Mr. WIRTH. Well, again, it seems to me the point that we are all looking at is the interrelatedness of all these issues and I, for one, don't feel comfortable that we understand it; that we've looked at it very carefully, that we understand what might happen in the area of conflicts of interest and various tie-ins; that we've developed the sort of firewalls between institutions that have characterized our financial structure pretty effectively in the last 50 years.
>
> Mr. VOLCKER. And I'm not going to argue with you that this legislation before the Senate committee solves all the range of problems that you are talking about.[5]

If, as this hypothetical case assumes, the customer does purchase a package of financial services from Sears in connection with buying a house, an arms-length evaluation of each step in the process is less likely to occur than in a case involving separate and independent providers of the same services. The mortgage banker may not have as great an incentive to scrutinize the credit-worthiness of the homebuyer for a house at that price and interest rate if the sale increases the profits of the affiliated realtor and, thus, of the conglomerate as a whole. The possibility that credit standards might be relaxed could be enhanced if the sale were also tied to the purchase of furnishings, carpet, appliances and homeowners insurance. And the insurer in this case might have less incentive to give an independent assessment of the value of the property or, assuming he disagrees with the valuation of the realtor and mortgage lender, to charge a higher premium to protect his own operations if that might jeopardize packaging the entire transaction.

---

[5] *Financial Restructuring: The Road Ahead.* Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, April 4, 1984, Serial No. 98-144, pp 164-165; 166-167.

It should be noted that, while Chairman Wirth assumed that Sears' California thrift would provide the mortgage credit in this hypothetical case, the mortgage could have been financed by Sears' mortgage banking affiliate which operates nationwide and which, because it does not hold a large portfolio of mortgages, is more likely to issue mortgage-backed securities.

Each of the affiliates may assume that its relationship to the others and to the parent company minimizes the risk it might face as an independent entity. Its goal may be to maximize the profits of the company as a whole by contributing to a greater volume of transactions.[6] If an error is made in assessing the creditworthiness of the homebuyer or the value of the property, the losses incurred by the mortgage banking and insurance affiliates will be absorbed by the parent company. Management will not suffer. But the customer may lose his home and the economy gets a failure it should not have had.

In the next phase of this series of transactions—the pooling of mortgages and the issuance of mortgage-backed securities underwritten by the securities affiliate of the financial services conglomerate and insured by its mortgage insurance affiliate—the investor may be subject to greater risk. Assuming the possibility that credit standards have been relaxed,[7] the issue is whether or not an adequate evaluation of the risks involved will take place. The company that insures the mortgage pool might be expected to perform that function in its own interest. But if its viability is not at stake because it is not an independent company, it may not act in its own best interests. And it will be less likely to act in the interests of the investor if the interests of the investor conflict with those of the parent company.

The securities affiliate has an equally crucial role. In a segregated financial system, it is assumed to be a middleman, acting impartially in the interests of both issuers and investors. But, the existing regulatory framework requires that a securities firm pay particular attention to the interests of investors by exercising "due diligence" in the performance of its underwriting role. The underwriter has responsibility for ascertaining that all material facts pertaining to the issue are made known to investors and, if not satisfied that that is the case, it has the option to refuse to underwrite the issue to avoid the costs and loss of confidence associated with a potential investigation by the SEC.

Would the incentive to exercise due diligence be as great in cases where the cross-marketing or tying of services within a financial conglomerate is the rule rather than the exception? Would the costs of a regulatory reprimand offset the gains enjoyed by the conglomerate as a whole as a result of a higher volume of business spread across a number of transactions and affiliates?

---

[6] For example, "Dean Witter, for which Sears paid $610 million, earned an average annual return of 3.3% in the three years that ended last December 31. And Sears increased its initial investment by lending Dean Witter $300 million. Analysts regard Dean Witter's performance as disappointing, though that isn't financially significant to Sears" (David B. Hilder and Steve Weiner, "Difficult Fits: Big Brokerage Houses are Problem Children for Their New Parents", *The Wall Street Journal*, September 13, 1985, pp. 1 and 12).

[7] The savings and loan industry believes that mortgage bankers do not have "the same stake in the quality of the mortgage loan assets as the traditional portfolio lender". The majority of mortgages originated by mortgage bankers are sold to other lenders. Therefore, delinquencies and defaults will have less impact on the viability of these institutions than on thrifts that hold a substantial volume of mortgages in their own portfolios. (Dennis J. Jacobe, Senior Vice President and Director of Research, U.S. League of Savings Institutions, "Mortgage System Under Pressure as New Finance Forms Alter Market", *American Banker*, January 25, 1985, p. 12).

For an example of problems relating to the valuation of property and other risks involving mortgage-backed securities, see "Bank America's Charge Linked to Inflated Issue", *The Wall Street Journal*, January 29, 1985, p. 3.

But, some would argue, the investor himself may be a stabilizing factor in this scenario. Almost all mortgage-backed securities are bought by institutional investors that have the resources and market clout to obtain accurate information about risk. Their increasingly pervasive presence in securities markets has been used repeatedly to justify some relaxations of investor protection standards on the grounds that only "sophisticated" investors engage in certain types of transactions.

On the other hand, the institutional investor has fewer options than the individual to withhold funds from the market or to avoid asset diversification. Investment managers cannot afford to concentrate funds in insured bank deposits or Treasury bills and cannot easily avail themselves of such alternatives as antiques, paintings, jewelry, etc. And if a "bloated debt structure" results from the emphasis on volume in a less regulated financial environment, as Henry Kaufman of Salomon Brothers believes has occurred,[8] the resulting overall deterioration of credit quality may make both institutional and individual investors more vulnerable, regardless of the amount or quality of information available.

Nor is the financial conglomerate itself free from risk in this scenario. Losses sustained by its insurance (or any other) affiliate would necessarily weaken the company as a whole. Consolidating financial services and creating synergisms that result in a higher level of profit than that earned through specialization may require a different (and perhaps higher) level of managerial skills to assess the appropriate mix of intra-company risks and rewards. But those may be skills that subordinate fiduciary responsibility to the imperatives of efficiency and market survival. More of the risk may be shifted to customers, and may result in a deterioration in credit quality, more defaults and greater losses to investors.

CONSOLIDATION AND FINANCIAL STABILITY: THE ROLE OF BANKS

This report has repeatedly called attention to the market power of banks. Banks have unique powers not only because they can tie sources and uses of funds and create deposits by lending, but because they are the only institutions that issue liabilities to all sectors of the economy and extend credit to all private and public borrowers. As E. Gerald Corrigan, President of the Federal Reserve Bank of New York has noted, these powers give banks a unique role in the financial system:

> In a very real way, banks are the primary source of liquidity for all other classes and sizes of institutions, both financial and nonfinancial. . . . Even in the "normal" course of events, the direct and standby credit facilities provided by banks are the foundations upon which other credit markets depend for their vitality. This relationship takes on special significance, however, in periods of selec-

---

[8] Henry Kaufman, Executive Director, Salomon Brothers, Inc. and Vice Chairman, Phibro-Salomon Inc. "Dangers in the Rapid Growth of Debt: The Need for a National Policy Response", talk delivered before the National Press Club, Washington, D.C., January 16, 1985.

> tive or generalized financial stress. . . . [and] underscores the importance of rigorous and impartial credit judgements by banks. This, in turn, provides a particularly relevant context in which concerns about the commingling of banking and other interests should be evaluated.[9]

As President Corrigan points out, other financial sectors are heavily dependent on bank credit to maintain liquidity even in "normal" circumstances. The securities industry, for example, relies on bank credit to finance inventories and extend loans to customers. The importance of their banking relationships is such that, as a senior partner of a major investment bank testified:

> The securities industry worries whether banks, if they become our competitors, will still be enthusiastic, reliable lenders to us.[10]

This statement reflects the concern that an expansion of services offered by banks could impair the objectivity of their credit decisions with important repercussions for the viability of other financial institutions and the overall stability of credit markets. But the possibility that banks might be less willing to act as disinterested lenders in a period of financial stress could have more serious implications for stability.

The primary objective of the Federal Reserve Act of 1913 was to ensure the availability of liquidity and credit to all regions and financial and economic sectors in the "normal" course of events as well as in the event of financial stress. The structure of the Federal Reserve System is indicative of its reliance on banks as a channel for the back-up system that provides liquidity through Federal Reserve discount and lending facilities. These mechanisms have been used repeatedly and with considerable success in the more volatile financial environment of the last decade to prevent problems in individual institutions or markets from spreading throughout the system. The following discussion is intended to illustrate how these mechanisms work and how they may be undermined by the expansion of bank powers.

The Federal Reserve's efforts to stem the crisis in the commercial paper market in the wake of the Penn Central bankruptcy was a notable achievement. In 1970, Penn Central defaulted on $83 million of commercial paper, precipitating a crisis of confidence that resulted in the inability of other, sound borrowers to roll over their notes. The Federal Reserve responded by opening its discount window and encouraging banks to lend the additional funds supplied by the central bank to companies experiencing distress because of investors' unwillingness to buy commercial paper. In addition, it exempted large negotiable certificates of deposit (CDs) from interest rate ceilings. This had the effect of making CDs competitive with commercial paper and encouraging investors to switch to CDs, supplying more funds to banks and enlarging their lending capacity and ability to deal with the crisis.

---

[9] E. Gerald Corrigan, "Are Banks Special?", *Annual Report 1982*, The Federal Reserve Bank of Minneapolis, pp. 10–11.

President Corrigan uses the term "banks" in a generic sense to reflect the extension of banking powers to other depository institutions by the 1980 and 1982 Acts.

[10] Statement of John C. Whitehead, Senior Partner, Goldman Sachs & Co., *The Future of Financial Markets*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., July 14, 1983, Serial No. 98-42, p. 192.

The effort to deal with this crisis was so successful that it was, in effect, institutionalized. Banks began to offer back-up credit lines to commercial paper issuers (for a fee) on the implicit assumption that, in the event of a crisis in which all or many lines would be drawn down, the Federal Reserve would assist in supplying the funds needed to meet these contingent obligations. Confidence in the commercial paper market was restored[11] and the volume of paper issued in the latter half of the 1970s rose to historically high levels in relation to total credit flows.

This back-up mechanism originated, however, in a period when banking functions were still relatively segregated from other financial functions. After passage of the Bank Holding Company Act Amendments of 1970, bank-related commercial paper became the fastest growing segment of the market as bank holding companies and their affiliates increasingly relied on these instruments to fund their non-banking activities.[12] The larger bank holding companies have been able to raise funds more cheaply through commercial paper issues than nonfinancial companies—perhaps because of their size and the size of their issues, and because of their affiliation with federally insured institutions.

But banks' usefulness as guarantors for the paper of nonfinancial companies may have been impaired by their direct involvement as competing issuers on so large a scale. In the event of a loss of confidence in the commercial paper market, banks' impartiality in lending funds supplied by the Fed to nonbank issuers would be less certain. Although individual banks would be limited by law in the amount of funds they could supply to their own affiliates, reciprocal arrangements with other banks could result in more favorable treatment for bank-related issuers.[13]

Equally important, a crisis of confidence in the commercial paper market could spill-over into the market for CDs because these instruments are near-substitutes and because the inability of a bank holding company to roll over its own paper could cause investors to lose confidence in the affiliated bank. This would significantly lessen the ability of the larger banks that are the primary guarantors of nonbank-related commercial paper issuers to meet their obligations and continue to meet the credit needs of other nonfinancial and financial sectors. It would also reduce the effectiveness of the Federal Reserve's efforts to act as lender of last resort to this market or prevent repercussions in other credit markets.

Restoring liquidity and confidence could be further complicated if one or more bank holding company affiliates were the source of the problem. Had REITs [14] been managed (rather than merely advised) by banks and been major commercial paper issuers, a more serious crisis might have emerged in 1975 than was experienced in 1970 with less likelihood of success in preventing ripple effects throughout the financial system.

---

[11] Confidence is a more important factor in the commercial paper market than in other credit markets because the instrument involved is an unsecured promissory note.

[12] The limits on loans by banks to their non-banking affiliates were a factor in this growth. Moreover, commercial paper has typically been a cheaper source of funds than loans from unaffiliated banks.

[13] For example, Bank A could avoid the rules by lending Federal funds to Bank B for onlending to affiliates of Bank A; or, using its correspondent network, could increase its deposits in several banks for the same purpose.

[14] Conflicts of interest involving REITs (real estate investment trusts) are discussed below.

CONFLICTS OF INTEREST

Because the functions of financial intermediaries were relatively specialized after passage of the Glass-Steagall Act, concerns about conflicts of interest faded. However, the threat to the existing structural framework posed by the unregulated one-bank holding company movement in the 1960s raised the issue anew and prompted Federal Reserve Board Chairman William McChesney Martin to make the following assessment of the dangers inherent in permitting nonfinancial companies to own banks and vice-versa:

> If a holding company combines a bank with a typical business firm, there is a strong possibility that the bank's credit will be more readily available to the customers of the affiliated business than to customers of other businesses not so affiliated. Since credit has become increasingly essential to merchandising, the business firm that can offer an assured line of credit to finance its sales has a very real competitive advantage over one that cannot. In addition to favoring the business firm's customers, the bank might deny credit to competing firms or grant credit to other borrowers only on condition that they agree to do business with the affiliated firm. This is why . . . if we allow the line between banking and commerce to be eased, we run the risk of cartelizing our economy. . . . Just as we have seen the country's largest banks join the new wave of one-bank holding companies, we could later see the country's business firms clustering about banks in holding company systems in the belief that such an affiliation would be advantageous, or perhaps even necessary to their survival.[15]

Although the Bank Holding Company Act Amendments of 1970 precluded conflicts of interest like those described above by maintaining the separation of banking and commerce, it gave rise to new opportunities for self-dealing by authorizing banks to form nonbanking affiliates to engage in activities "closely related to banking". Meanwhile, the movement of nonbank financial institutions into other financial sectors and the entry of commercial firms into nonbank financial activities had similar consequences. Moreover, the more recent exploitation of the nonbank bank loophole has revived the concerns expressed by former Chairman Martin about potential conflicts of interest involving affiliations between banks and commercial firms.

As the existing and prospective examples of conflicts of interest discussed in this section suggest, opportunities for self-dealing appear to be inherent in the holding company structure. Certainly, managing that structure has important implications for credit and investment decisions. The issues they raise are important enough to be considered in proposals for regulatory restructuring, with or without further changes in the structure of the financial system itself.

---

[15] Quoted in Senate Report 91-1084, p. 3, and in *Compendium of Papers Prepared for the FINE Study*, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Cong., 2nd Sess., June 1976, Book I, p. 264.

Insurance companies

Baldwin-United's default on its single premium deferred annuities is a classic case of the kinds of self-dealing within a holding company that may weaken institutions and lead to failure. In this case, the insurance arm offering the annuities invested heavily in new insurance subsidiaries acquired by the holding company.[16] The loss to policy-holders occurred when the value of these investments was wiped out by the collapse of the affiliated companies.[17] Although the insurance subsidiary that sold the annuities had not violated state law by investing more than 25 percent of its premiums in its affiliates,[18] the decision to invest in overextended affiliates is an example of the temptations faced by consolidated enterprises and an indication that, while such practices can be tolerated in nonfinancial companies, they may be inappropriate for financial intermediaries, and existing safeguards may be inadequate.

There is a difference of opinion about whether single premium deferred annuities are an insurance product or a security.[19] Many of these annuities have been marketed by securities firms. Following the Baldwin-United default, several major securities firms agreed (in response to suits brought by annuity holders) to reimburse their own customers for the amount initially invested together with a modest return in relation to original expectations or to what might have been earned on the annuities or on other investments. Subsequently, insurance companies announced that they would make contributions to state insurance guaranty funds to cover other policy holders.[20]

In this case, the type of conflict of interest involved in the affiliate relationship did not include opportunities for cross-marketing services.[21] Had that been the case—had Baldwin-United been af-

---

[16] Baldwin-United's problems were compounded by the fact that investors were promised unrealistic rates of return on the annuities.

[17] Although this is one accepted view of the problem, Stephen J. Friedman offered another in a letter to the Subcommittee, June 5, 1985:

> The problem in Baldwin-United was not investments in over-extended affiliates. It was the illiquidity that resulted from the affiliate transactions, the lack of soundness of the SPDA structure (resulting in negative cash flow), and adverse interest-rate movements.

[18] Most state laws dealing with transfers of funds between insurance companies and their affiliates provide safeguards similar to those provided by the Bank Holding Company Act. Banks are not allowed to loan more than 20 percent of total assets to nonbanking affiliates of the holding company.

[19] See testimony of James P. Corcoran, New York State Superintendent of Insurance, and Scott Greathead, Office of the Attorney General of the State of New York, *Financial Deregulation in New York State*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Session, December 14, 1983, Serial No. 98-90, pp. 40-42; 44-46.

[20] Testimony of John J. Creedon, President and Chief Executive Officer, Metropolitan Life Insurance Company, *Financial Restructuring: The Road Ahead, op. cit.*, May 17, 1985, pp. 627-628.

[21] It may have involved other conflicts of interest, however. For example, Scott Greathead, testifying on behalf of Attorney General Robert Abrams of the State of New York, made the

Continued

filiated with a major securities firm that acted as the primary distributor of its annuities—the likelihood that the securities firm would have been in a position to reimburse policy holders is remote. Nor is this a remote concern. The consolidation of both insurance and securities activities by such firms as Prudential-Bache, Merrill Lynch, Sears and American Express and the merger between Equitable Life and Donaldson, Lufkin & Jenrette are likely to accelerate a trend toward using the nationwide offices of a securities firm to market the insurance products (including annuities) of its insurance affiliate.[22]

There are also examples of conflicts of interest involving affiliations between insurers and commercial companies.[23] Many of the Fortune 500—the largest U.S. commercial firms—have formed offshore entities in the Carribbean to handle their own insurance requirements. The benefits to the commercial enterprise included opportunities to defer premium contributions as well as substantial tax benefits. The formation of captive companies outside the domestic regulatory structure may have given large companies significant advantages in competing with smaller firms in the same line of business. It may also have resulted in less than adequate coverage in some cases because an independent evaluation of risk was not made—an outcome that could undermine shareholder protection since shareholders would not know what the true insurance requirements of the company might be.

When the Internal Revenue Service ruled that the tax benefits would only be available if at least 50 percent of the insurance affiliate's business was with unaffiliated companies, the potential for conflicts of interest was enhanced. The IRS ruling did not restrict or inhibit preferential treatment for the parent company and continuation of these practices could have meant that third party customers received less favorable treatment than their competitors[24] and might have been exposed to greater risk than if insured by an independent insurer. While these affiliates were offshore and most of their third party business was reinsurance rather than direct

---

following observations about actual and potential conflicts of interest during hearings before the Subcommittee in December, 1983:

> Of course we have to look at one of the key questions here which is the potential for conflict of interest. If all these banks get into insurance, insurance into banks, and oil companies into both, we have to make sure that there is a clean separation. There is an interesting lawsuit going on right now against Merrill Lynch in the Baldwin situation. The allegations are that Merrill Lynch lent, I believe, $90 million to Baldwin and sat as a creditor on Baldwin's board, knew very well Baldwin's financial situation, but still continued to sell the stock to the public, not telling the public what they knew.
>
> And they are asserting there was an obvious conflict of interest. If you have that situation now, what do you do in the future? The same analogy could be made toward insurance companies and banks who lend out substantial amounts of money. Also there is concern about pension funds and small businesses, marginal businesses who need credit from banks, when they go to banks to buy their insurance and pension products just to secure their credit line.

(*Financial Deregulation in New York State, op. cit.*, December 14, 1983, pp. 40–41).

[22] For example: ". . . 15% of [Prudential-Bache's] insurance agents and stock brokers work together, sharing sales prospects and commissions. In five years, Prudential hopes the number will rise to 50%" (Hilder and Weiner, *op. cit.*, p. 12).

[23] See Part III, Chapter 3 for further discussion of these affiliations.

[24] On the other hand, third party customers of captive insurers appear to have been higher risk customers that tended to be shunned by more conventional reinsurers. Some believe the bad business went to the captives—much to the relief of underwriters elsewhere. If so, the customers of the captive insurers were not disadvantaged but shareholders of their parent companies may have been.

underwriting, most were acting as reinsurers for primary underwriters of other U.S. companies. Thus the competitive advantages resulting from preferential treatment as well as the increased risk could indirectly affect the entire domestic insurance market.

Investment banks

A potential conflict of interest situation involving securities firms developed in the late 1960s as a result of the shift in the structure of securities firms from partnerships to public companies. To address the problem, the National Association of Securities Dealers (NASD) devised limited safeguards to prevent securities firms from acting as sole managing underwriters of their own securities.[25] But these safeguards focus primarily on the pricing of the initial offering—the immediate concern since, obviously, a market valuation was not available—rather than on the appropriate requirements for due diligence investigations of the financial condition of the firm under this special circumstance. As a result—and as securities firms have acquired wholly or partially owned nonsecurities affiliates such as mortgage banks, commodity dealers, etc.—differences in the quality of information about their financial condition and that of competing issuers have grown more significant and may now constitute a major gap in investor protection.

This concern was addressed in legislation[26] reported by the Subcommittee on Telecommunications, Consumer Protection and Finance in June 1984, and, in July 1984, by the Subcommittee on Commerce, Transportation and Tourism. It would have authorized the SEC to issue rules and regulations governing securities firms' underwriting of their own issues or those of affiliates, and the marketing of services and products of nonsecurities affiliates, to prevent conflicts of interest and inappropriate sales practices, ensure full disclosure and fair pricing, and maintain the soundness of securities firms.

---

[25] Under Schedule E of the NASD rules, at least one other managing underwriter is required to participate in the offering *unless* the securities are rated by an independent, recognized rating agency or are additional securities of an outstanding class which is openly traded. The limited nature of the restrictions and safeguards provided by this rule (which focus only on the pricing of issues) are illustrated by a recent listing of SEC registered public offerings (negotiated and competitive) for a one-month period ending June 30, 1985. During that period, a number of major investment banks underwrote securities for their parent holding companies or affiliates. All were in conformance with Schedule E of the NASD rules but the absence of additional underwriters in many of these cases implies a significant difference in the performance of due diligence with respect to securities firms and their affiliates as compared with other issuers.

The listing shows that First Boston was the *sole* underwriter for its own negotiated stock offering while Dean Witter, Shearson Lehman Brothers and Merrill Lynch brought in other securities firms to assist them in underwriting negotiated debt issues for affiliates. Salomon Brothers, too, was in conformance with the NASD rule, using a second underwriter in a negotiated stock offering for Phibro-Salomon. But the weakness in the existing rules is best exemplified by the fact that, in June 1985, Salomon Brothers was the *sole* underwriter for 4 negotiated debt offerings by Salomon Brothers Mortgage Securities totaling $600 million and *sole* underwriter for 4 negotiated debt offerings by Salomon Capital Access Corp. totaling $230 million ("Financing Record", *Institutional Investor*, August 1985, pp. 37-40).

It should be noted, however, that securities firms are precluded from *dealing* in any securities of their parent or affiliates because the resale of any repurchased securities of an affiliate requires re-registration with the SEC. However, these restrictions do not apply when the securities firm is acting in an *agency capacity* buying or selling for third parties, *provided* the securities firm does not solicit customers for purchases of the affiliate's securities or make recommendations to buy the securities. Its research coverage must be limited to factual information about the firm.

[26] Section 210 of the Financial Institutions Act of 1984 (H.R. 5881). As discussed in Part I, Chapter 4, this section was adopted on a vote of 9-6.

While the securities industry had been quick to point out that bank involvement in underwriting or other nonbanking activities could lead to conflicts of interest, they ignored the potential for their own nonsecurities activities to have similar consequences, and argued that this section of the bill constituted a significant extension of SEC authority into an area outside the purposes of the Securities Acts. Their argument overlooked the fact that the NASD had already promulgated rules dealing with conflicts of interest and that the Bank Holding Company Act had addressed the issue of self-dealing when banks—like securities firms now—had adopted the holding company structure.

Opportunities for conflicts of interest involving securities firms are increasing now that underwriters are becoming affiliated with insurance companies. Securities firms are not generally precluded from conducting business with insurance affiliates and can buy and sell securities to and from the insurance affiliate in both a principal and agency capacity.[27] Thus, an underwriter could as easily "dump" unsold securities into the portfolio of its insurance affiliate as into trust accounts managed by a bank affiliate—one of the more egregious forms of abuse that led to passage of the Glass-Steagall Act separating commercial and investment banking.

Moreover, in a case in which an insurance company had loaned funds to a troubled manufacturer or retailer in the form of a private placement, its securities affiliate could arrange a bail-out by underwriting a public offering of securities, the proceeds of which would be used to retire the issuer's debt to the underwriter's affiliate.[28] The incentive of the securities firm to perform its due diligence function under these circumstances might be weakened. For example, it might ignore the fact that the issuer failed to state that it planned to use the proceeds to retire debt, or that they would be used to retire debt to a particular creditor—omissions that could result in false signals about the financial condition of the issuer.

Of course, the SEC might prevent such an omission from occurring. But, currently, the SEC relies on the self regulatory organizations (SROs) and due diligence by securities firms to ensure the accuracy of disclosure. If the due diligence function were significantly weakened by conflicts of interest, the SROs and the SEC would have to assume greater responsibility for assuring that issuers meet disclosure requirements and might have to assume larger roles in examining and supervising securities firms as well.[29]

---

[27] This statement is corroborated in a memorandum entitled "Financial Services: The Question of Regulatory Oversight," in which Sears acknowledges that there are no restrictions on Dean Witter's transactions with Allstate except in the limited area described in the following footnote.

[28] The Sears memo cited in the preceding footnote states that the only restriction involving such practices is in the venture capital situation. Dean Witter cannot make an *initial* public offering for a company if Allstate has acquired securities of that company in a private placement transaction and is selling its securities at the same time, as part of the registered offering.

[29] It is true that, as J.P. Morgan & Co., Inc. notes, a "securities affiliate would be subject to civil and possibly criminal liability under the federal securities laws if it failed to disclose all material facts about the financial condition of the issuer and the use of proceeds of the offering" (*Rethinking Glass-Steagall*, J.P. Morgan & Co., Inc., December 1984, p.V). But such a statement overlooks the fact that there are real gaps in enforcing disclosure.

As noted, the SROs have primary responsibility for reviewing disclosure statements. The SEC provides a back-up by reviewing about one-third of all prospectuses and about 22 percent of all annual reports. With respect to securities firms, the SROs review disclosure statements for those

Continued

Affiliations between securities and commercial firms also increase the potential for conflicts of interest. The problems associated with a securities firm underwriting the issues of a retailer or manufacturer with which it is affiliated are like those associated with the underwriting of its own issues or those of any other affiliate. But there may be an aspect to this type of affiliation that is also similar to that described by former Federal Reserve Board Chairman Martin in outlining his concerns (quoted above) about affiliations between banks and commercial enterprises. For example, the commercial enterprise may agree to deal with a given supplier only on condition that the supplier agrees to do business with its securities affiliate. This may significantly constrain the options of the supplier in terms of raising funds and—if the potential loss of sales were great enough—the supplier might accept higher financing costs as preferable to a lower volume of business.

But there is another emerging area involving conflicts of interest that is linked to changes in the role of the securities industry itself. As *The New York Times* reports: "Increasingly, investment bankers in the United States are acting like their merchant banking counterparts abroad." [30] That is, they are investing for their own accounts in leveraged buyouts and real estate and taking venture capital positions. And, as a corollary, they are becoming active members of corporate boards to monitor the progress of the companies they invest in.

Those firms that are actively engaged in merchant banking argue that it will become an increasingly important source of income "as competitive pressures drive down the income from standard underwritings." [31] But not all securities firms are happy with this trend. Some believe that merchant banking could "taint" the advice a firm offers clients, which should be "totally objective".[32] Others also see the "potential conflict" in such relationships,[33] which will tend to increase cross-selling.

Equally important, the effect of using capital resources for long-term investments could be to impair liquidity needed for the traditional risk-taking involved in market-making and underwriting. Historically, U.S. investment bankers have only bought the shares of companies in connection with these activities and do not hold them long. But when they engage in merchant banking activities in which they act as investors, capital may be tied up for many

---

(currently 20) firms that are publicly owned and, in fiscal year 1985, the SEC performed oversight reviews for only four of those firms. Disclosure statements for those firms that are part of a holding company (Dean Witter, for example) are included in statements filed by their parent companies and may or may not be reviewed by the SEC.

Nor would current examination procedures ensure that conflicts of interest involving securities firms are fully disclosed. For example, the NASD routinely examines about one-third of the 6,200 broker-dealers that deal with the general public. SEC oversight of examinations conducted by the NASD generally covers about six percent of these firms and involved 447 oversight examinations in fiscal year 1985 (information supplied by SEC staff).

[30] Fred R. Bleakley, "Wall St.'s Merchant Bankers", *The New York Times*, November 19, 1984, pp. D1, D5.

[31] *Ibid.*, p. D5.

[32] *Ibid.*, p. D1.

[33] Professor Samuel Hayes of the Harvard Business School notes that: "One obvious problem with this is that they lose their detached perspective with respect to counseling the company and they compromise their impartiality with respect to advising competitors, too" (David A. Vise, "Investment Bankers Throw Own Money Into The Ring", *The Washington Post*, December 30, 1984, pp. F1, F6).

years. Because investment banks are now publicly owned, they have more capital to invest. First Boston has invested $100 million or about 15 percent of its capital base in venture capital, real estate and leveraged buyouts, while Merrill Lynch has invested more than $1 billion—almost half of its $2.2 billion capital base—in an even broader range of activities.[34]

Although by no means exhaustive, this discussion illustrates some of the ways in which the consolidation of financial functions may increase the potential for conflicts of interest as a result of the proliferation of mergers of nonbanking financial institutions and functions and/or their affiliations with commercial companies. It suggests that increasing competitive opportunities by expanding the functions of financial institutions can disadvantage their customers and increase, rather than reduce, competitive inequities within the financial system. More important, it will lead to a loss of impartiality that can undermine the market system itself and result in serious economic losses.

The current focus on issues involving depository institutions may tend to obscure the trend toward a rising level of conflicts of interest outside the banking sector and the extent to which it may compromise impartiality and contribute to a deterioration in the quality of credit. It may be true that, as many would argue, conflicts of interest arising from bank affiliations with other financial or commercial activities could lead to more serious abuses and a higher level of risk. But existing opportunities to enhance competitive advantages by consolidating nonbanking financial services and combining these services with commercial activities are sufficiently rewarding to perpetuate a trend that, left unchecked, could increase fragility and undermine confidence in the financial system as a whole.

Many believe that the conflicts of interest described here would also apply to banks if their powers were expanded to include financial and commercial activities used in these examples. Morgan Guaranty Trust Company argues that this is not true:

> An effective and economically sound approach to controlling conflicts of interest—based on disclosure, regulation, and judicial remedies rather than on the separation of activities that might cause such conflicts—has been developed under the U.S. securities laws. Moreover, economic incentives to maintain the good will of clients are strong and significantly limit the exploitation of conflicts of interest in any business. Analysis indicates that affiliation between a bank and a securities firm would not present conflicts of interest greater than or substantially different from those now faced by either entity individually, and that the existing regulatory framework would deal effectively with these potential conflicts. There is no need to prohibit bank affiliates from underwriting and dealing in corporate securities because of such potential conflicts.[35]

---

[34] *Ibid.*, pp. F1, F6.
[35] *Rethinking Glass-Steagall*, *op. cit.*, p. IV.

Continued

As this section suggests, however, that argument is flawed. The securities laws do not deal adequately with conflicts of interest The supervisory resources of the SEC and self-regulatory organizations are insufficient to discover whether or not self-dealing is disclosed. As noted, the SEC reviews only a fraction of all disclosure statements and currently does not routinely review those of securities firms. And there are no other means for monitoring intra-company transactions other than through disclosure since SROs can only examine the securities affiliate in a diversified financial conglomerate. As a spokesmen for one of the SROs, the American Stock Exchange, stated:

> The SROs cannot effectively reach persons outside their respective memberships, making it difficult to conduct comprehensive investigations and forcing reliance on the already scarce resources of the SEC to complete investigations and take enforcement action against "members of the public" over whom the SROs have no jurisdiction.[36]

With respect to the loss of impartiality, the integration of such functions as mortgage origination and the issuance of mortgage-related securities with the underwriting function is a case in point. This form of vertical integration—whether involving securities firms and their mortgage banking affiliates or banks and thrifts and their securities affiliates as proposed by the legislation adopted by the Senate in 1984—could significantly undermine investor protection because an arms-length evaluation of decisions relating to each of these functions would no longer occur. And, again, the result could be loss of market efficiency and confidence and a further deterioration in credit quality.[37]

Banks and bank holding companies

The operations of bank trust departments also provide illustrations of existing examples of conflicts of interest. As the FINE Study and earlier analyses pointed out, regulators have permitted banks to invest large amounts of trust account funds in non-interest-bearing deposits.[38] Banks are also permitted to acquire trust

---

Sears makes a similar argument: "In summary, the federal securities statutes combined with the plethora of regulations governing the activities of the securities industry serve as a significant regulatory tool to prohibit unsound business practices. These statutes, rules and regulations specifically address inter-company transactions and are currently sufficient to deal with problems which may arise ("Financial Services: The Question of Regulatory Oversight").

[36] Richard O. Scribner, Executive Vice President, American Stock Exchange, "The Technological Revolution in Securities Trading: Can Regulation Keep Up?" *Technology and the Regulation of Financial Markets*, Edited by Lloyd White and Anthony Saunders, Lexington Books, D.C. Heath & Co., 1986 (p. 12 of unpublished manuscript on file with the Subcommittee).

[37] The concerns about combining the functions of originating, issuing and underwriting mortgage-backed securities also apply to other forms of securitized credit. The importance and role of securitized credit instruments are discussed in Part II, Chapter 4.

[38] Roy A. Schotland, "Bank Trust Departments and Public Policy Today", *Compendium of Papers Prepared for the FINE Study, op. cit.*, Book I, footnote 16, pp. 222-223.

That this is still true is evidenced by a recent suit filed by beneficiaries of trust funds (including the Damon Runyon—Walter Winchell Cancer Fund) held by Bank of America (see "Los Angeles Judge Absolves Bank of America in Trust Policy Suit", *American Banker*, January 25, 1985, p. 3). While acknowledging the practice, the court held that the bank had not violated regulations, had adequately explained and justified its conduct, and had shown that the methods used in operating corporate accounts (such as "zero balance accounts") to avoid loss of interest income would not be appropriate to trust accounts. Attorneys for the plaintiffs stated that the case will be appealed.

Continued

property for their own use without competitive bidding. By expanding bank profits, these practices give banks an unfair advantage in competing with nonbank investment advisors. They also reflect the disadvantages of surveillance by regulators whose emphasis is on soundness rather than fiduciary responsibility and support the views of those who argue that trust and pension fund management activities should be undertaken by separate subsidiaries of the holding company and regulated by an agency (the SEC) whose function is to protect beneficiaries of the funds rather than the bank and its depositors.

There are also examples of actual or potential conflicts of interest involving bank holding company affiliates. Banks did not require their affiliates to keep compensating balances against loans in the period when these balances were ordinarily included in the terms of credit. This gave their nonbank affiliates a cost advantage in competing with independent finance companies, factors and leasing companies that, as discussed below, may have contributed to their ability to dominate these lines of business in so short a period of time. But the affiliates could also provide advantages to the bank itself in handling their banking business if only, as Dr. Edward S. Herman has argued, by adding to bank size and "pulling power".[39]

The fact that the Federal Reserve Board has paid relatively little attention to conflicts of interest between banks and holding company affiliates[40] has made it very difficult for outside analysts to document problems. There is, however, an inherent problem in assessing conflicts of interest within a holding company "where the very structure warrants, often necessitates, complex internal arrangements and transactions"[41]—a problem that was tackled in the 1930s in dealing with abuses by public utility holding companies and led to passage of the Public Utility Holding Company Act.

In any event, some conflicts of interest only emerge when a holding company affiliate experiences problems and the bank undertakes a rescue operation. The FINE Study offered an illustration of this kind of development in the mid-1970s and its implications for credit decisions:

> In 1975, and early 1976, numerous BHCs [bank holding companies], including some of the largest such as Chase Manhattan, purchased assets from the REITs [real estate investment trusts] they had sponsored, at prices which raised the gravest question about the transactions' soundness for the purchasing banks. But until the SEC acted upon that question by calling for more realistic accounting

---

More recently, 100 national banks—including the Chase Manhattan Bank and the Bank of Boston—were accused by the Comptroller of the Currency of mishandling estate and trust funds by failing to invest income from the accounts at prevailing market rates, and were ordered to repay lost interest on the accounts. Spokesmen for the banks responded that they believed they were in full compliance with the rules and vowed to fight demands for reimbursement ("Banks Accused of Mishandling Funds", *The Washington Post*, September 28, 1985, p. C1).

[39] See the quotation from Professor Herman's testimony at footnote 83 below.

[40] As the discussion of tie-ins (below) indicates, the absence of data on nonbanking affiliates of bank holding companies suggests that Federal Reserve surveillance of transactions between banks and their affiliates is less than rigorous.

[41] Roy A. Schotland, "Bank Holding Companies and Public Policy Today", *Compendium of Papers Prepared for the FINE Study, op. cit.*, p. 273.

disclosures, bankers and bank regulators treated the matter as merely part of the necessary "workout" of the REIT problem, with no implications for banking soundness. This, despite the fact that a small BHC in Florida and a major one in Tennessee failed during that period as a result of over-exposure to bad real estate loans which had been held originally by mortgage banking affiliates but which at the end, in unsuccessful "work-out" efforts, were loaded into the affiliated banks. Also in 1975 and 1976, banks experienced an almost unprecedented contraction in general loans outstanding, but this too was usually explained as entirely the result of economic depression and of borrowers' need to strengthen their balance sheets. Although many bankers commented publicly about their increased caution in making new loans, few suggested that the reduced lending might well be the result, in an important part, of the immediately preceding go-go plunge into the BHC structure, with unduly high prices being paid for acquisitions, with bank management at least substantially distracted from their area of expertise, and with many managers wholly absorbed in activities largely or entirely new to them.[42]

As banks' experiences in advising REITs and other new holding company operations of that period suggest, a further expansion of banks' powers may have important effects on soundness and the impartiality of their credit decisions. The aftermath of the REIT problems differs from the aftermath of banks' plunge into securities activities in the 1920s only with respect to the amount of losses to banks and the scale of credit contraction. In view of these earlier experiences, banks' current problems in working out loans to developing countries,[43] and energy, real estate and farm loans would seem to indicate that a degree of caution in permitting a further expansion and deregulation of bank activities is warranted.

Pension funds

A discussion of conflicts of interest involving pension funds was presented by Robert A.G. Monks, former Administrator of the Office of Pension and Welfare Benefit Programs, U. S. Department of Labor, in testimony before the Subcommittee on Telecommunications, Consumer Protection and Finance on May 22, 1985. While the potential or actual abuses described by Mr. Monks are in some ways unique to pension fund management, they illustrate the ways in which conflicts of interest arise. Moreover, these problems exist under the current institutional regulatory structure in one of the fastest growing sectors of the financial services industry and they involve the other major financial sectors—banks, insurance companies and securities firms—all of which have affiliates involved in managing pension fund assets. The concerns and issues raised by Mr. Monks are contained in the following excerpts from his prepared statement:

---

[42] *Ibid.*, p. 247

[43] For example, one analyst of the LDC debt problem estimated that the nine largest U.S. banks would lose one-third of their capital and have to contract lending by approximately $160 billion if loans in an amount equal to one year's principal and interest payments by the three largest Latin American debtors—Brazil, Mexico and Argentina—had to be written off (William R. Cline, *International Debt and the Stability of the World Economy*, Institute for International Economics, September 1983, p. 38.) While this is close to being a worst-case scenario, it indicates the magnitude of the problem and its potential impact on credit volumes. It also suggests that banks should not be encouraged to commit capital to new activities until these loans are worked out.

> The fact of the matter is that violations of ERISA due to conflicts of interest abound on all sides. In order to understand why, consider the problems posed by voting the shares held by pension funds: voting is difficult to delegate; it is inconvenient for delegatees to exercise; and it creates conflicts of interest. The investment manager retains clients by delivering good performance; no plan sponsor adds to the performance measure credit for thoughtful consideration of corporate governance issues. Yet on the other hand, take the money manager who makes a serious effort to vote shares responsibly; voting against the anti-takeover proposals of a current or prospective client is seldom perceived as the best way to establish a warm relationship . . .
>
> Bear in mind that ERISA plans must be invested and managed for the "exclusive benefit" of the plan participants and beneficiaries. This requirement encompasses the exercise of voting power every bit as much as the investment power. But consider the dilemma this poses for major ERISA money managers; the banks, insurance companies, and securities conglomerates. Let's take the hypothetical Company A, whose ERISA funds are managed by Bank B. The Bank also manages pension portfolios for ten other large companies, and has purchased Company A stock for all ten. Enter Company A's pension officer one day, with an additional ten million in pension funds for the Bank to manage, and coincidentally, a small request. Company A's annual meeting is coming up, and a certain anti-takeover measure is on the proxy; Company A surely would appreciate it if Bank B could make sure all the proxies it holds are voted the right way. Needless to say, the Bank justifiably worries about keeping Company A as a valued client. But it also holds trustee responsibility for ten other pension portfolios, whose best interest may well lie in Company A being available for acquisition.
>
> Are such exchanges taking place? In the Wall Street Journal of May 10, an unnamed money manager was quoted as saying that he in fact had received calls from Unocal officers on exactly this issue. When one considers the few large entities that control the bulk of pension fund assets—in 1984, the one hundred largest companies owned more than half the assets—it is clear that there are extensive overlapping networks of "connected" companies who have commercial relationships with virtually every significant financial service provider. The number of phone calls that could be arranged to a fiduciary with an 'unaccept-

able' view of exercising his responsibilities boggles the mind—it is a very large number.

* * * * *

During the summer of 1984, Carter Hawley Hale (CCH) successfully defended against a takeover. One of the critical factors was the role of Bank of America, trustee for the employees' stock savings plan, which turned out to hold 40% of the outstanding ownership of the company. Bank of America, whose directors included CCH Chairman Philip Hawley (who also chaired the executive compensation committee of the Bank's Board), declined to tender shares at the offered price, which was the highest ever. Confusion still reigns. "The biggest question is why the Department of Labor has not acted on its apparent intentions to sue the Bank of America, which is the trustee for Carter Hawley's employee profit-sharing plan. In its June 21 proxy statement for today's shareholder meeting, Carter Hawley stated that the Labor Department had notified the Bank of America on May 9 of the agency's intention to seek an injunction against the bank, charging violations of the Employee Retirement Income Security Act of 1974 . . . While the Labor Department has not detailed its concerns, they are said to center on the bank's purported failure to evaluate the impact of the tender offer on the participants' benefits and its failure to recommend a vote either way to the employees. There is also some question as to . . . conflict of interest" (Isador Barmash, *The New York Times*, July 26, 1984, p. D4.)[44]

CROSS-SELLING AND TYING FINANCIAL SERVICES

As individual financial institutions expand the range of their activities, opportunities for cross-selling services increase. Cross-selling may merely reflect an institution's efforts to inform the customer of other services available. It may also involve the suggestion that tying two or more services together will lower their cost. Or it may involve explicit "packaging" arrangements where access to one service depends on the purchase of another. At the very least, increased opportunities for tie-ins will tend to distort the objectivity of the advice offered by institutions to their customers.

Tie-ins are difficult to police, equally difficult to detect. As one former Justice Department official pointed out, the tie-in may be exclusively in the borrower's mind and reflect a placating action to assure access to the one financial service he needs.[45] Customers in smaller markets without the ability to tap national or international markets may be particularly vulnerable to either implicit or explicit cross-selling arrangements. The customer himself must have market power to resist. Thus the consolidation of financial functions may result in an increase in opportunities for effective tie-in arrangements even when there are many competing sources of services.

---

[44] Statement of Robert A.G. Monks, *Shareholder Interests and Corporate Takeovers*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Energy and Commerce Committee, U.S. House of Representatives, May 22, 1985, unpublished. For further discussions of issues related to pension fund management, see Part II, Chapter 4 and the section on concentration below.

[45] Remarks of former Assistant Attorney General McLaren, cited by G.R. Hall in "Anticompetitive Impacts of Expanded Bank Service Lines", unpublished paper for the President's (Hunt) Commission on Financial Structure and Regulation (1971), and quoted in *Compendium of Papers Prepared for the FINE Study, op. cit.*, p. 266.

The segregation of financial institutions has tended to limit the potential for tie-ins. That consolidation of financial institutions and services increases that potential has been recognized in some Federal legislation expanding the powers of depository institutions. For example, authorization for banks to sell credit life insurance was accompanied by requirements that customers for bank loans be informed that insurance was not obligatory and that it could be provided by another institution. Even so, banks have better access to customers for credit life insurance than their competitors who, together with some state insurance regulators, complain that, as a result, bank charges have been higher and their performance worse than that of insurance companies.[46]

On the other hand, after a number of (mostly small) insurers began offering government-insured student loans, instances of abuse also began to surface. As *The Wall Street Journal* noted:

> State officials report numerous complaints from parents who say agents told them they had to buy life insurance policies to obtain loans for their children—only to find out later they easily could have gotten the same loan at a bank without any strings. Such tie-in arrangements are illegal in most states.[47]

As discussed in Part I, Chapter 2, there are a number of opportunities for consolidating financial functions that do not require legislative authority with the result that opportunities to provide regulatory safeguards dealing with tie-ins do not arise. For example, it is possible to combine investment and mortgage banking, property and casualty insurance underwriting, dealing in commodities and real estate activities without a change in Federal or State law. Moreover, any one (or all) of these services may be combined with any number of commercial activities. As a result, a major retailer, Sears, has been able to form or acquire a realty company, a state-chartered (unitary) thrift, a mortgage banking affiliate, an insurance company, a securities firm, and a state-chartered, limited purpose (nonbank) bank. Meanwhile, recent changes in state law have made possible the combination of life insurers and securities firms. As discussed, the number of such combinations has proliferated in recent years.[48] None of them are subject to restrictions on tie-ins and, in the absence of regulatory surveillance, very little information on instances of (or abuses associated with) tie-ins has been developed.

---

[46] *Financial Restructuring: The Road Ahead, op. cit.*, pp. 579–580.

[47] Richard Gibson, "Insurers Forcing People to Buy Policy to Qualify for Student Loan", *The Wall Street Journal*, September 10, 1985, p. 33.

[48] See Chart B above.

The FINE Study documented a number of instances of cross-selling of services based on a 1974 Federal Reserve Board Study of 27 major bank holding companies, and called attention to referrals between their leasing and banking businesses.[49] These were the first analyses of tie-ins and cross-marketing involving the banking system since the passage of Glass-Steagall and they remain an important source of evidence of the risks that consolidation poses for traditional regulatory objectives.

In the most recent study done by Federal Reserve staff on banking and leasing, the author concludes that "bank holding company leasing affiliates are both riskier and less profitable than large, publicly traded corporations." [50] The results of this study, published in 1980, are based on sources from 1973–1975. The limited amount of empirical research is explained mostly by a lack of data [51] and is an indication of significant inadequacies with respect to the supervision and regulation of nonbank affiliates of bank holding companies.

Leasing, as an alternative method to the direct purchase of equipment, is increasingly attractive and "it has been speculated that 15 to 20 percent of all capital equipment purchases are financed by leasing." [52] The banking industry is playing an important role as evidenced by the fact that, ". . . in 1974 one-third of all members of the American Association of Equipment Lessors were associated with banks either as departments or subsidiaries of banks or BHCs." [53] Findings of the 1980 study indicate that compared with large independent companies, "BHC leasing subsidiaries are less profitable, they hold less cash, have less equity capital, and they carry more short-term debt than publicly traded leasing companies." [54] On the other hand, leasing divisions and subsidiaries of banks (as opposed to BHCs) "are as profitable as the independents, but are riskier in terms of liquidity, equity capital, and debt." [55]

---

[49] Roy A. Schotland, "Bank Holding Companies and Public Policy Today", *Compendium of Papers Prepared for the FINE Study, op. cit.*, Book I, p. 266.

[50] Stephen A. Rhoades, Staff Economist, Federal Reserve Board, "The Performance of Bank Holding Companies in Equipment Leasing", *The Journal of Commercial Bank Lending*, October 1980, p. 53.

[51] The most current information that the Federal Reserve can provide upon request is a list of BHC subsidiaries involved in leasing as of year-end 1983. This does not include the leasing subsidiaries of banks. Unfortunately, they also do not have information on BHC and banks' leasing activity by industry—to determine a bank's exposure to a particular industry (*e.g.*, airlines, shipping, etc.). The growth in leasing activity and banks' increased involvement in it have both been established. Ability to assess the implications requires current data, which is presently the missing link.

[52] Leonard Rochwarger, "Bank Involvement in Equipment Leasing Grows", *American Banker*, October 21, 1974, pp. 20, 24, and 68.

[53] Rhoades, *op. cit.*, p. 55.

[54] *Ibid.*, p. 60.

[55] *Ibid.*, p. 60.

Possible explanations for the differences in performance between BHC (and bank) leasing subsidiaries and independent firms cannot be substantiated with the existing data. However they can be hypothesized. Federal Reserve Board staff economist Rhoades suggests that "the low profitability exhibited by BHC subsidiaries might be due to the upstreaming of funds from the subsidiary to the parent BHC through management fees." He notes the possibility that "leasing subsidiaries of BHCs cannot operate as effectively as independent firms that do not have to answer to a large, bureaucratic organization." And finally, "the relatively high-risk position of BHC and bank subsidiaries may be due to a belief that the parent organization will come to the rescue of the leasing subsidiary if it should experience financial difficulty" (*Ibid.*, p. 60). Many observers would add that the indirect benefits of deposit insurance might play a role as well.

As these findings suggest, tie-ins between banking and leasing could have significant implications for soundness. Equipment leasing offers companies an alternative to other forms of long- and short-term financing.[56] But it may also tend to increase the overall debt exposure of a company to a single institution when both banking and leasing services are provided. In the event that the bank holding company decides it cannot prudently increase its exposure, the company may be left without alternative sources of credit. Its ability to tap other sources of bank credit may be limited by the size of its exposure to its original creditor.[57] And if a significant portion of its equipment is already owned by that creditor, the relative imbalance between its assets and liabilities may discourage potential investors in a new equity or bond offering.

If the company's inability to obtain other sources of credit weakens its competitive position, its creditor, too, may be threatened. Since the bank holding company already owns a significant portion of the company's equipment, there would be fewer assets that could be sold to repay loans to the bank in the event of failure. Of course, the leasing affiliate itself could sell the assets. But would it be in a position (or have the same legal obligation) to use the funds to offset the bank's losses?

Obviously, too little is known about tie-ins between leasing and banking or other financial activities to support or refute this hypothetical example. But it would appear that the consolidation of these two functions could limit the options of a borrower, and that, in the event of failure, a diversification of services does not necessarily provide added protection to the lender.

As noted above, the consolidation of financial services may result in increased opportunities for effective tie-in arrangements even when there are numerous competing sources of services. Over time, however, tie-ins may tend to reduce the number of competing institutions at the expense of those that offer the least number of services. At the very least, the absence of a real or perceived need to "placate" an institution that offers fewer services could undercut customer loyalty to that institution and undermine its competitive position.

THE CONCENTRATION OF FINANCIAL RESOURCES

Most discussions of the adverse effects of concentration tend to focus on competitive issues. It is generally believed that fewer firms are associated with less competition and higher costs to customers. However, competition can be very intense in markets with relatively few institutions. The Eurobanking market is a very competitive market, with low earnings spreads relative to the cost of funds, even though only a few of the largest banks from individual countries participate in that market. In the case of the United States, nine money center banks account for 61 percent and 24 large banks (including these nine) for 80 percent of all foreign loans held by U.S. banks.[58]

---

[56] Bank holding company affiliates lease such "big ticket" items as airplanes, ships and machinery as well as vehicles, office equipment, etc.

[57] Lines of credit syndicated by a group of banks is the more common method of financing for large companies. However, given limits on loans to individual customers, the exposure problem occurs with equal frequency even when syndications are used. The large borrower is less likely to be able to form a second syndicate if the original group of banks refuses new credits.

Competition in U.S. securities markets is also intense.[59] Although the 10 largest securities firms account for 55 percent of underwriting revenues and 33 percent of commissions, the profitability of traditional investment banking activities is declining.[60] The top investment banks are now earning more as advisers in mergers and acquisitions and from merchant banking activities. The real anti-competitive effect of these highly concentrated markets is that spreads are so low on transactions of such size that smaller institutions and customers are kept out.[61] A concentrated but competitive market tends to exclude participants on the basis of size, not price.

Such developments suggest that it may be desirable to have a larger number of institutions operating in each market segment to improve customer access to services. Another reason might be to reduce the size of individual intermediaries. There is a growing awareness that the current size of some institutions may present problems in terms of the social costs of failures and the monetary cost of government intervention to prevent failures or cushion their impact. For example, many banking observers argue that, as a result of geographic deregulation by the states, " 'too big to fail' banks could increase in a few years from today's dozen to 25, 30 or more." [62]

Equally important, a larger number of institutions increases the number of decision-makers. The number and variety of institutions is critical in providing the diversity, multiplicity and heterogeneity that characterize a market system. Thus, the primary concern about the concentration of financial institutions is that it results in too few private lenders and investors choosing winners and losers—a result that could be as harmful as centralizing this function in government.

This section examines the current level of concentration within the major sectors of the financial services industry—securities firms, banks and thrifts, insurance companies and money managers—both in terms of institutional dominance and asset concentrations. As the evidence presented shows, there is already a very high level of concentration that may have important implications for the soundness and stability of the financial system. As market forces assume a larger role in disciplining institutions, the result may be a higher rate of failures of fewer and larger institutions. The data on concentration have equally important implications for the stability of the economy in terms of the need for a balanced distribution of capital and credit, and for the market system itself as investment and credit decisions increasingly rest in the hands of fewer decision-makers.

---

[58] Federal Financial Institutions Examination Council, *Country Exposure Lending Survey: June 1985*, Statistical Release E.16(126), November 6, 1985.

[59] Morgan Guaranty would deny that securities markets are competitive, arguing that the very large profits of major investment banks, as measured by returns on equity and compensation for partners and executives, reflect excess costs to customers that could be reduced by allowing banks to engage in securities activities and thus increase the number of firms offering services (*Rethinking Glass-Steagall, op. cit.*, pp. 36-38). However SEC Chairman Shad believes the securities industry is competitive (*The FDIC Securities Proposal and Related Issues*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, June 16, 1983, Serial No. 98-46, p. 44). Others, including Morgan Guaranty, argue that banks should be allowed to engage in securities activities precisely because they are a more efficient use of capital—that: "Corporate securities activities generate substantially higher returns on capital employed than commercial banking activities", and would augment a bank holding company's capital, its ability to absorb losses and to support an increase in bank assets (*Rethinking Glass-Steagall, op. cit.*, p. 22). In other words, this latter argument is a proposal for distributing (currently) high investment banking profits across the financial system in order to "increase the system's stability" (*Ibid.*, p. 22).

[60] Vise, *op. cit.*, p. F1; Bleakley, *op. cit.*, p. D1.

[61] The size of Eurobanking transactions and the exclusion of small borrowers is discussed in Part II, Chapter 1. The issue of the size of transactions in securities markets is discussed by Morgan Guaranty (*Rethinking Glass-Steagall, op. cit.*, pp. 32-33) and by *Business Week* ("Playing with Fire", September 16, 1985, p. 83).

[62] Robert Trigaux, "In Case of Big-Bank Failure . . .", *The American Banker*, October 16, 1985, p. 22.

TABLE 4.—COMPARISON OF CONCENTRATION RATIOS OF MAJOR FINANCIAL SERVICES SECTORS

[Year-end 1984]

Industry	Number of institutions in industry accounting for 50 percent of total industry resources.[1]	Percent of total number of institutions in industry accounting for 50 percent of resources[1]
Securities firms	12	0.15
Banks	64	.55
Thrifts	132	4.17
Life-health insurers	11	.51
Property-casualty insurers	33	1.86
Institutional investors[2]	37	12.33

[1] The relevant measure of concentration used for the securities industry is total revenue. For all other sectors, the measure is assets. For a more detailed description of the data, see tables 5 through 9.

[2] Based on data for only the 300 top money managers, some of whose assets are included in data for other financial services sectors.

Source: See sources on tables 5 through 9.

Institutional concentration

Overview. The U.S. financial services industry is highly concentrated at the top, remarkably diversified at the bottom. In each sector, a very small number of institutions accounts for half of that sector's activity and resources. As Table 4 shows, less than one percent of the total number of firms in the securities, banking and life insurance industries, dominate those industries, while about two percent of the total number of property-casualty insurers and a little more than four percent of all thrifts control half the resources in those sectors. This and the subsequent tables bear out the findings in Chart A above: the major financial sectors are dominated by a handful of very large institutions with a large number of small institutions competing at the fringes.

Institutional investors are a special case. Many of the institutions included in this category are listed (and their assets are included) in separate tables for life-health and property-casualty insurance companies.[63] Moreover, some of the assets of pension funds are managed by the insurance, banking and securities firms on the list. Thus, the data reflect a significant amount of double counting. And because the available data do not include the "fringe" institutions in this category, it appears less concentrated in terms of the number of institutions than the other major financial sectors.

---

[63] See tables 6, 7, 8, and 9a.

Nevertheless, institutional investors as a whole are a very small group that manage an enormous pool of financial assets. For example—using a different basis for comparison—the 37 institutional investors that manage half of all assets of beneficiaries control about $1.2 trillion of assets while 64 banks that hold half of all banking assets account for $1.4 trillion, the thrift industry as a whole (3,159 institutions) holds about $1 trillion, all (2,134) life insurers manage $700 billion and all (1,773) property-casualty insurers manage a little less than $300 billion of assets.

The various tables validate the widely accepted view that the securities industry is the most highly concentrated of the major financial sectors in terms of *function*. But in terms of the *control of financial resources*, the banking industry dominates the financial services industry and is the most concentrated at the top levels. Ten bank holding companies—less than one-tenth of one percent of all banking organizations[64]—hold about $724 billion of banking assets—an amount equal to the total assets of all life insurers, almost three times the assets of all property-casualty insurers, and only about $250 billion less than total assets held by the thrift industry—and manage an additional $247 billion of assets for beneficiaries.

Moreover, the reach of the top 10 bank holding companies in terms of function is greater than the data for banks suggest.[65] They play a major role in more than one sector of the financial services industry. Overall, their dominance in the banking industry (where they control over 25 percent of total banking assets), in underwriting and trading securities[66] and in money management[67] gives them a disproportionately large voice in making decisions about the allocation of financial resources.

Nevertheless, high levels of concentration exist in each of the major sectors of the financial services industry as the data presented in the following sectoral analyses show:

The securities industry. Using data on capital, total revenues, securities commissions and underwriting profits to measure concentration levels in the securities industry reveals a very high level of dominance by a very small group of firms. The data in Table 5 show that the securities industry is a sector that contains a relatively large number of institutions compared with the total number of thrifts and insurance companies. However, many of the firms included in the listing are mutual funds of which many are managed by insurance companies. Thus the data may not give an accurate representation of the number of independent broker-dealers but it does provide convincing evidence of concentration.

---

[64] Banking organizations include bank holding companies and independent banking institutions and their affiliates.

[65] See table 6.

[66] As table 2 in Part I, Chapter 4 shows, banks currently are eligible to underwrite about 50 percent of all securities (including U.S. government securities) issued in the domestic capital market and are eligible to underwrite an even greater range of securities abroad. Under the provisions of the bill passed by the Senate in September 1984, they would be eligible to underwrite 75 percent of all securities issued in U.S. markets. As the data in footnote 69 (below) indicate, their present share of domestic markets for bank eligible securities is significant even though the data only reflect participation by the largest banks.

For the large banks, however, trading activity is a significant share of their total business and revenues. For example, a 1986 investment report reveals that Citicorp's daily *domestic* trading volume averaged $13 billion in 1985 ($3 trillion for the year) and that its global trading revenue rose at a 24 percent compound growth rate from 1981-85 to $210 million. By 1985, Citicorp had gained a dominant or substantial share in major international markets with a 30 percent share of swaps and Eurocommercial paper distribution, seven percent of U.K. equities, six percent of U.K. government securities, 5-10 percent of Swiss franc new issues, and two percent of Eurodollar bond sales and Austrian and German debt securities distribution ("Citicorp: Banking on Investment Banking", ***Bank Weekly***, Salomon Brothers, Inc., April 11, 1986, p. 5).

[67] See table 9b below.

TABLE 5: CONCENTRATION IN THE SECURITIES INDUSTRY[a]
($ millions, year-end 1984)

Number of Firms	% of total Number	Measure of Concentration	% of Total
		Capital[b]	
10	0.12	$9,769	40.64
18	0.23	12,220	50.00
7802[c]	100.00	24,037	100.00
		Revenue	
10	0.13	18,705	46.67
12	0.15	20,276	50.00
7584[c]	100.00	40,076	100.00
		Securities Commissions	
10	0.22	3,091	33.04
29	0.65	4,709	50.00
4404[c]	100.00	9,355	100.00
		Underwriting Profits	
10	0.80	1,785	54.83
9	0.72	1,681	50.00
1248[c]	100.00	3,255	100.00

TOP 10 FIRMS[d]

Firm	Capital	% of total Capital
1. Merrill Lynch & Co Inc	$2,215	9.21
2. Shearson Lehman Bros Inc	1,896	7.88
3. Salomon Bros Inc	1,577	6.55
4. Dean Witter Fin Serv Inc	1,237	5.14
5. E.F. Hutton Group Inc	1,020	4.24
6. Goldman Sachs & Co	859	3.57
7. First Boston Inc	659	2.74
8. Prudential-Bache Sec Inc	618	2.57
9. PaineWebber Group Inc	564	2.34
10. Drexel Burnham Lambert Group Inc	561	2.33

---

a. Source: Quarterly FOCUS Reports, Directorate of Economic and Policy Analysis, Securities and Exchange Commission.

b. Capital includes total ownership equity and subordinated debt.

c. Includes all firms reporting dollar amounts in the indicated category. The total number differs in each category because all firms do not do underwriting, all do not have securities commissions (e.g. those who only underwrite mutual funds and those who sell partnerships in oil and real estate ventures) and all do not have revenues (e.g. those with negative revenues and start-up firms).

d. Data for top 10 securities firms (based on capital), which are from SIA 1985 directory and resulted from questionaires completed by individual firms, differ from SEC data used in upper portion of table. SEC data on capital of individual firms are not public information.

As noted, securities underwriting is generally considered to be the most concentrated area of the financial services industry. Certainly the data in Table 5 support that contention. Far fewer firms are engaged in underwriting than in other securities functions and the top 10 firms account for over half of all underwriting profits.

But these data are incomplete. They include only SEC registered broker-dealers and not banks that also earn profits from underwriting and trading securities.[68] The top 10 banks' share of underwriting (and trading volume and profits) in the government securities, municipal securities and Eurobond markets is substantial.[69] Bank participation in the government securities market, however, has not significantly reduced concentration in that market. As a recent GAO report states, the 36 primary dealers (composed of 15 banks, 12 SEC-registered broker-dealers and nine unregistered government securities firms) underwrite the majority of new Treasury issues and account for about 75 percent of all government securities trading volume, while regional banks have a substantial share of remaining market activity.[70]

Many believe that regulatory changes have had the unintended effect of increasing concentration in the securities industry. Ending negotiated commissions in the 1970s appears to have accelerated the pace of merger activity within the industry while the inauguration of shelf-registration (SEC Rule 415) reduced the number of firms involved in corporate underwriting.

Shelf-registration permits a company to file a registration statement that can be utilized at any time over a two-year period. Such flexibility is useful in a volatile interest rate environment because it permits companies to issue securities under more favorable market conditions. But it has tended to concentrate the underwriting function in a few of the largest investment banks because the underwriter is under time pressure that may not allow syndicates to be formed and, thus, a high level of capital is required to support a greater volume of large issues by a single underwriter.[71] The fact that only 18 securities firms account for half the total capital in the industry virtually assures that very few will participate in underwriting the issues of large companies, most of which register under Rule 415. Moreover, shelf-registration tends to exacerbate the differences in relative costs of raising funds for small- and medium-size issuers compared with large companies because they do not issue securities frequently or in large amounts and therefore cannot use the exemption.

---

[68] See footnote 66 above and see Table 2, Part I, Chapter 4, for a listing of securities eligible for underwriting by banks.

[69] A recent study by Arthur Anderson (cited by the SEC in arguing that its rule requiring banks or their subsidiaries that engage in certain securities activities to register with the agency as broker-dealers be upheld) predicted that banks will handle 16 percent of all securities trades next year and 21 percent by 1990 (Leon B. Wynter, "Judge Upholds Rule on Banks' Securities Business", *The Wall Street Journal*, October 31, 1985). But banks' share of markets for securities that are eligible for bank underwriting is much higher. For example, 16 large banks (seven in New York, four in California, four in Illinois and one in Massachusetts) accounted for 35 percent of state and local general obligation bonds underwritten by the top fifty underwriters of these issues in 1984, compared with 20 percent for regional securities firms and 45 percent for New York-based securities firms (Public Securities Association, *Municipal Bond Developments*). And among the government securities dealers reporting to the Fed, banks held 27 percent of average daily positions in the first nine months of 1985 and accounted for 26 percent of average daily trading volume of $103.4 billion (information supplied by Federal Reserve Board staff).

[70] *Survey of the Federal Reserve System's Supervision of the Treasury Securities Market*, A Discussion Paper Prepared by the General Accounting Office for the Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 99th Cong., 1st Sess., May 1985, pp. 13, 56.

[71] Securities Industry Association, *Submission on Rule 415* (to the Securities and Exchange Commission), September 1983, pp. 7–8. See also *Rethinking Glass-Steagall, op. cit.*, p. 30.

The banking industry. Banking is the largest segment of the financial services industry with total assets of more than $2.8 trillion. As Table 6 shows, the level of concentration in the top tier of the industry is about the same as the level for property-casualty insurers, less than the level for life-health insurers, and greater than the level in the top tier of the thrift industry—all of which are much smaller industries as measured by both the number of institutions and the amount of assets.

Table 6: CONCENTRATION AMONG BANKS
($ millions, year-end 1984)

Number of inst.[a]	% of total Number	Assets[b]	% of total Assets
10	0.08	$ 723,940	25.61
64	0.55	1,415,842	50.16
11451	100.00	2,822,531	100.00

TOP 10 INSTITUTIONS

Institutions	Assets	% of total Assets
1. Citicorp	$150,586	5.33
2. BankAmerica Corp	117,680	4.16
3. Chase Manhattan Corp	86,883	3.07
4. Manufacturers Hanover Corp	75,714	2.68
5. J.P. Morgan & Co Inc	64,126	2.27
6. Chemical NY Corp	52,236	1.85
7. Security Pacific Corp	46,117	1.63
8. First Interstate Bancorp	45,544	1.61
9. Bankers Trust Corp NY	45,208	1.60
10. First Chicago Corp	39,846	1.41

---

[a] List of banks covers 11,451 banking organizations that own 14,350 insured banks. The list includes 5 savings banks that are not members of the FHLBB and 2 FHLBB-member banks that are not FSLIC-insured, and therefore are not included in the listing for thrifts provided by the FHLBB used as a source for Table 7.

[b] Includes holding company assets for those companies that report a Y-9 schedule (domestic holding companies with $50 million or greater in consolidated assets, year-end) and foreign and domestic banking assets for other depository institutions.

SOURCE: Table of depository institutions ranked by total assets, Board of Governors of the Federal Reserve System, as compiled by Subcommittee staff.

But because of the size of the industry, the importance of its role in the financial system and the economy, and the customer protections that apply to bank deposits, concentration in banking has larger implications in terms of economic stability and credit allocation. And the fact that the three largest bank holding companies hold over $355 billion of assets—more assets than all property-casualty insurers; more than half the assets of all life-health insurers; more than a third of the assets of all thrifts and over 12.5 percent of all bank assets—that they manage an additional $81 billion for beneficiaries, and that the aggregate capital of these three institutions amounts to about 90 percent of the total capital of the entire securities industry, suggests that an excessive level of concentration already exists within the financial services industry. The industry as a whole is now dominated by a small number of very large bank holding companies.

Passage of the Bank Holding Company Act Amendments of 1970 may have been a factor that contributed to this development; the expansion of banks overseas was another. The largest banks account for a greater share of total consolidated assets (including nonbanking and foreign assets) than of total deposits. As noted, nine of those banks hold about 61 percent of all foreign loans and account for the bulk of all nonbanking assets held by bank holding companies.[72] As the FINE Study pointed out, the expansion of banks into nonbanking activities such as leasing and factoring resulted in a very sharp increase in banks' share in these financial sectors in a very short period of time.[73] By 1975—only five years after passage of the Bank Holding Company Act Amendments—bank holding companies controlled a substantial number of the largest firms engaged in activities that the Federal Reserve Board had determined to be "closely related to banking".[74] Their entry into discount brokerage has followed a similar pattern with four of the seven largest discount brokers now controlled by banks.[75]

The thrift industry is considerably less concentrated than other financial sectors. Nevertheless, there is a substantial amount of concentration in the top tier of institutions with three-tenths of one percent of all thrifts accounting for over 15 percent of total assets. None of the top ten thrifts are as large as the top ten banks, and only the top four are comparable in size to major life insurers. But, as a group, the top ten thrifts are twice as large as the top ten property-casualty insurers, and the current fragility of the industry enhances the likelihood of an increase in concentration as the assets and deposits of unsound thrifts are acquired by larger and sounder institutions.

---

[72] The fact that most nonbanking assets of bank holding companies are funded in the commercial paper market, where the scale of transactions precludes small issuers, contributes to this development. As in the case of access to the Euromarkets, access is denied on the basis of size, not price—a recurrent development in the current trend toward oligopolistic markets.

[73] See the discussion of tie-ins above.

[74] Roy A. Schotland, "Bank Holding Companies and Public Policy Today", *Compendium of Papers Prepared for the FINE Study, op. cit.*, Book I, pp. 241-246.

[75] Information supplied by the Securities Industry Association.

Table 7: CONCENTRATION AMONG THRIFTS
($ millions, year-end 1984)

Number of inst.	% of total Number	Assets	% of total Assets
10	0.31	$152,324	15.57
132	4.17	492,486	50.33
3159	100.00	978,514	100.00

TOP 10 INSTITUTIONS

Institutions	Assets	% of total Assets
1. American S&L	$28,918	2.96
2. Home Savings of America	23,892	2.44
3. Great Western Savings	21,756	2.22
4. Calif. Fed S&L	17,036	1.75
5. Glendale Fed S&L	11,602	1.19
6. Goldome FSB	11,193	1.14
7. World S&L	10,646	1.09
8. First Nationwide Savings Fed S&L	9,479	.97
9. First Fed of Michigan	9,029	.92
10. Gibraltar Savings	8,773	.89

SOURCE: Listing of FHLBB institutions (which includes FSLIC insured S&Ls and FSLIC/FDIC insured savings banks that are FHLBB members); the Federal Home Loan Bank Board.

Life-health insurers. The top ten life-health insurers have a dominant position in the industry comparable to that of the top ten securities firms.[76] Given the relatively large size of the industry in terms of assets, the important role it plays in securities markets, and the existing level of concentration, the trend toward mergers between life insurers and securities firms cannot be viewed as procompetitive. As the list of the top 37 money managers suggests,[77] there are already too few institutions accounting for the bulk of investment activity. A proliferation of mergers between these two financial sectors could significantly reduce the number of decisionmakers in the market.

---

[76] See table 8 as compared with table 5.

[77] See table 9.

Table 8: CONCENTRATION AMONG INSURANCE COMPANIES
($ millions, year-end 1984)

Number of companies	% of total Number	Assets	% of total Assets
LIFE-HEALTH			
10	0.46	$352,688	48.78
11	0.51	366,137	50.64
2134	100.00	722,979	100.00
PROPERTY-CASUALTY			
10	0.56	71,350	26.95
33	1.86	133,001	50.24
1773	100.00	264,735	100.00

TOP 10 COMPANIES

LIFE-HEALTH

Companies	Assets	% of total Assets
1. Prudential Ins Co of Amer	$78,924	10.91
2. Metropolitan Life Ins Co	67,354	9.31
3. Equitable Life Assurance Society	44,532	6.15
4. Aetna Life Ins Co	33,971	4.69
5. New York Life Ins Co	25,600	3.54
6. John Hancock Mutual Life Ins Co	24,671	3.41
7. Travelers Ins Co	23,302	3.22
8. Conn. General Life Ins Co	19,234	2.66
9. Teachers Ins & Annuity Assn of Am	19,205	2.65
10. Northwestern Mutual Life Ins Co	15,896	2.19

PROPERTY-CASUALTY

Companies	Assets	% of total Assets
1. State Farm Mutual Auto	$16,671	6.29
2. Allstate Ins Co	11,229	4.24
3. Aetna Casualty & Surety Co	7,869	2.97
4. Liberty Mutual Ins Co	7,362	2.78
5. Travelers Indemnity Co	5,416	2.05
6. State Farm Fire & Casualty	4,909	1.86
7. U.S. Fidelty & Guaranty Co	4,582	1.73
8. Continental Casualty Co	4,476	1.69
9. Fireman's Fund Ins	4,450	1.68
10. St. Paul Fire & Marine	4,386	1.66

SOURCE: Best's Life/Health Insurance Report, 1985, 80th ed. (AM Best Co), and Bests Property/Casualty Insurance Report, 1985, 86th ed. (AM Best Co).

Property-casualty insurers. Compared with other financial sectors, the property-casualty insurance industry appears relatively unconcentrated. Even so, no industry in which over half of total assets are controlled by less than two percent of the total number of firms can be viewed as free from concentration.

Property-casualty insurers constitute a comparatively small industry in terms of the number of firms and total assets, but one that operates primarily in a national market. An assessment of how the dominance of a few large firms affects the ability of smaller firms to compete in a nationwide market is needed but is beyond the scope of this report. Nevertheless, indications of undercapacity that have led commercial and financial companies to form their own insurance affiliates,[78] as well as the number of affiliations between major property-casualty insurers and nonfinancial companies, suggest that concentration may have some implications for the ability of this industry to expand capacity to meet the needs of actual and potential customers. Like the thrift industry, this sector has faced distress conditions conducive to further consolidations.

Institutional investors. As discussed, the data in Tables 4, 9, 9a and 9b include assets of insurance companies that have already been included in Table 8. Moreover, the data also reflect some double counting in cases involving pension fund assets that are managed by other institutions.[79] And they necessarily accord different treatment to banks and insurance companies (by including only managed assets of banks but all assets of insurance companies) to reflect differences in their functions as investors. Thus the totality of the financial market activity of the insurance industry is reflected in these data while only a portion of that of banks and securities firms is covered. A rough estimate for data on insurance companies' managed assets comparable to data for banks and securities firms listed in Table 9b is about $200 billion—two-thirds of the amount managed by banks and a little less than the amount managed by securities firms.

---

[78] For further discussion of this issue, see Part III, Chapter 3.

[79] For example, some of the institutions listed in the "other" category in Table 9b use insurance companies, banks and securities firms to manage some or all of their funds. Thus the dollar amounts of such funds may be included in more than one list in addition to the listing for the pension fund, and thus result in double counting.

Table 9: CONCENTRATION AMONG INSTITUTIONAL INVESTORS
($ millions, year-end 1984)

Number of firms	% of total Number	Assets	% of total Assets
10	3.33	$ 570,880	24.11
37	12.33	1,184,504	50.01
300	100.00	2,367,567	100.00

Top 10 firms

Firm	Assets	% of total Assets
1. Prudential Insurance Co. of America[a]	$90,691	3.83
2. Metropolitan Life Insurance Co.[a]	75,888	3.20
3. Aetna Life Insurance Co.[a]	75,187	3.18
4. Equitable Life Insurance Co.[a]	70,482	2.98
5. American Express	59,023	2.49
6. Merrill Lynch Asset Management	48,113	2.03
7. J.P. Morgan & Co[b]	39,160	1.65
8. Citicorp[b]	39,041	1.64
9. Bankers Trust Asset Management[b]	38,374	1.62
10. TIAA/CREF	34,921	1.47

---

a. Includes total assets of insurance companies, e.g. investments funded by premiums and assets managed for beneficiaries of pension funds.

b. Includes only those assets managed for beneficiaries, not assets funded by deposits.

SOURCE: Institutional Investor, "Ranking America's top money managers", August 1985, pp. 141-174.

***NOTE: Includes only top 300 firms in total number, which overlap with other financial service sectors.

BEST COPY AVAILABLE

Table 9a: Summary Breakdown of 37 Largest Institutional Investors by Sector

($ millions, year-end 1984)

	INSURANCE COS.[a]	BANKS[b]	SECURITIES FIRMS	OTHER
Number of Institutions	12	14	8	6
Total Assets	$519,765	$339,131	$223,991	$101,617
Assets as % of total Assets of top 300	21.95	14.32	9.46	4.29

---

a. Includes total assets of insurance companies, *e.g.* investments funded by premiums and assets managed for beneficiaries of pension funds.

b. Includes only those assets managed for beneficiaries, not assets funded by deposits.

SOURCE: *Institutional Investor*, August 1985, pp. 142-146.

TABLE 9b: Sectoral Breakdown of 37 Largest Institutional Investors
($ millions, year-end 1984)

INSURANCE COMPANIES[a]

Institution	Assets
Prudential	$90,691
Metropolitan	75,888
Aetna Life	75,187
Equitable Lf[c]	70,482
Cigna Corp	34,124
Travelers Corp	33,301
John Hancock	30,606
New England Mut	25,357
New York Life	25,058
State Farm	23,731
Kemper Fincl	22,491
Allstate[d]	12,849
TOTAL	$519,765

BANKS[b]

Institution	Assets
JP Morgan	$39,160
Citicorp	39,041
Bankers Trust	38,374
PNC Financial	29,506
Chase Manhattan	25,774
Mellon Bank	25,047
Wells Fargo	21,977
Security Pac	21,490
Manuf Hanover	21,369
First Chicago	16,297
BankAmerica	15,924
Northern Trust	15,599
Chemical NY Corp	14,986
1st Interstat.	14,587
TOTAL	$339,131

SECURITIES FIRMS

Institution	Assets
Amer Express	$59,023
Merrill Lynch	48,113
Fidelity Invst[e]	27,103
Dreyfus Corp[e]	23,870
Capital Group[e]	19,249
T. Row. Price[e]	17,665
Wellington Mgmt/ Thorndike, Doran, Paine & Lewis[e]	16,012
Dean Witter[d]	12,956
TOTAL	$223,991

OTHER

Institution	Assets
TIAA/CREF	$34,921
CA Public Emply	24,483
NY State Com Retirement Fund	22,077
Gen Elect Invt	16,357
Sears Roebuck Group[d]	3,011
Coldwell Banker[d]	768
TOTAL	$101,617

---

a. Includes total assets of insurance companies, e.g. investments funded by premiums and assets managed for beneficiaries of pension funds.

b. Includes only those assets managed for beneficiaries, not assets funded by deposits.

c. Includes $22,031 million of assets managed by Alliance Capital Management Corp., a subsidiary of Donaldson, Lufkin & Jenrette Securities Corp, now owned by Equitable.

d. A component of the Sears Roebuck group with combined assets under management of $29,584 million.

e. These firms could be more accurately categorized as Investment Advisors.

SOURCE: Institutional Investor, August 1985, pp. 142-146

As these calculations suggest, banks have a dominant role in money management both in terms of the number of institutions in the top tier and the amount of assets they control. While relatively little attention is paid to this aspect of banks' activities, it is clearly a very important function that enhances the critical role the industry plays in allocating resources. Thus, the degree of concentration that the data reveal about this banking function should not be ignored in any prospective effort to deal with the problem of concentration in the context of geographic or product expansion. Concentration ratios should be assessed in terms of consolidated assets [80] and in terms of market dominance with respect to the different markets in which banks operate.

But these same concerns apply to the insurance and securities industries. And the absence of an evaluation of changes in concentration levels among money managers as a result of mergers between large insurance and securities firms constitutes a major gap in implementing antitrust policy objectives.

While the implications of the increased dominance of institutional investors in capital markets is discussed elsewhere in this report,[81] the fact that so few institutions control so large a volume of assets has important implications on its own merits. It suggests that the large number of institutions in the U.S. financial system may not, *per se*, assure the degree of diversity and heterogeneity that is so widely assumed. If most of those institutions are operating at the fringes of predominantly nationwide markets, their impact as decisionmakers in those markets may be negligible even though they may play a larger role in regional or local markets.

Asset concentration

In the late 1960s, the House Banking Committee called attention to the fact that the holdings of bank trust departments were highly concentrated.[82] Several years later, the FINE Study revived the issue in the absence of any substantial degree of reform in the interval. By then, the 20 largest banks held almost half of all trust assets and a quarter of all trust assets were held by six New York banks and the Mellon Bank of Pittsburgh. The FINE recommendation was to grant trust powers to other depository institutions to increase competition. However, the major factor leading to concentration was the linkage between trust and other banking relationships—the ability of banks to exploit their unique market power to obtain business for their trust departments. As Dr. Edward S. Herman of Wharton noted:

> The capacity of the major banks to decide on the allocation of this volume of resources has a necessary power component. Thus, great commercial bank and trust department size feed on one another: a larger trust department, with the fuller complement of services that it offers to bank customers, and its direct contribution to bank depos-

---

[80] As opposed to domestic banking assets or deposits.

[81] See Part II, Chapter 4.

[82] *Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy*, Staff Report for the Subcommittee on Domestic Finance, Committee on Banking and Currency, U.S. House of Representatives, 90th Congress, 2nd Session, July 1968.

> its, float, and other advantages to the bank, adds to bank size and pulling power. And greater bank size and scope increases its attractiveness to trust accounts. This gravitational force plus the enormous size of these trust bank power aggregations suggest, at the very least, the desirability of precautionary limits on large trust bank mergers and on trust portfolio concentrations in individual securities, even in the absence of measurable damage or abuse.[83]

As Dr. Herman's statement implies, the concentration problem was not confined to the amount of assets controlled by the largest banks. Their holdings were also highly concentrated. Unlike insurance companies and investment companies (mutual funds), bank trust departments have been free of restrictions on the percentage of holdings that can be invested in a given company. This reflects the fact that, in the past, some trusts or estates were highly concentrated in the stocks of closely held companies. Over time, the justification for such an exemption has eroded. For example, the FINE Study pointed out that a single bank trust department, Morgan Guaranty, held over five percent of the stock of 85 companies with assets of over $200 million in 1974 and accounted for over 20 percent of total trading in the stocks of 16 of those companies.[84]

The FINE recommendation was that bank trust departments be required to diversify their assets and be limited to no more than five percent of a single company except in the case of small companies or closed companies held in trust or estates. But even with additional Congressional studies of asset concentrations in bank trust departments,[85] this recommendation has not been advanced subsequently in either legislative or regulatory proposals involving financial restructuring.

Since then, a significant degree of concentration in the management of pension funds has developed as well. By year-end 1982, the top 25 banks, insurance companies and investment advisers managed $324 billion, or over half, of the total of $569 billion of assets held in all private plans at that time.[86] Their holdings are highly concentrated as well. Although ERISA requires a prudent diversification of the assets of individual retirement plans, it does not limit the holdings of an outside manager who, as most do, manages more than one plan. Thus, if a manager is hired by 10 plan sponsors, he may hold no more than 10 percent of the shares of a given company in one plan, but could, theoretically, control 100 percent of the shares of the company. Such an extreme degree of concentration is highly unlikely. But—as in the case of bank trust departments—the absence of limitations on the aggregate holdings of multi-plan managers has important implications for corporate governance as well as other issues related to the efficiency of, and confidence in, securities markets.

---

[83] Edward S. Herman, "Trust Activities and Their Regulation," Prepared Statement, *Financial Institutions and the Nation's Economy (FINE) Discussion Principles*, Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Currency and Housing, U.S. House of Representatives, 94th Cong., 1st Sess., Part I, p. 330.

[84] Roy A. Schotland, "Bank Trust Departments and Public Policy Today", *Compendium of Papers Prepared for the FINE Study, op. cit.*, Book I, pp. 211-215.

For a more current indication of levels of asset concentration and their implications for corporate governance, see the statement of Robert A.G. Monks (quoted above at footnote 44).

[85] *See* the various staff studies issued by the Subcommittee on Reports, Accounting and Management, Senate Committee on Governmental Affairs: *Disclosure of Corporate Ownership* (Sen. Doc. 93-62, March 1974), *Institutional Investors Common Stock* (Sen. Doc. 94-247, May 1975), *Corporate Ownership and Control* (Sen. Doc. 94-246, November 1975), *Voting Rights in Major Corporations* (Sen. Doc. 95-99, June 1978)), and *Structure of Corporate Concentration: Institutional Shareholders and Interlocking Directorates Among Major U.S. Corporations*, staff study, Committee on Governmental Operations, U.S. Senate, 96th Congress, 2nd Session, December 1980.

[86] Alicia H. Munnell, "Who Should Manage the Assets of Collectively Bargained Pension Plans?", *New England Economic Review*, July/August 1983, pp. 19-20.

Since 1982, however, there have been increases both in the number of pension fund managers and the number of plans using more than one manager. The January 21, 1985, issue of "Money Management Letter", a publication of *Institutional Investor* (Vol. X, No. 2), for example, reports that the $3.8 billion Illinois Teachers Retirement System has decided to diversify its asset base by adding two new investment firms to the 14 that already manage its assets. Historically, the Illinois System has hired only firms that manage over $1 billion in assets. The new firms reflect its decision to use smaller firms with less than $1 billion under management to test "the theory that performance suffers as firms grow in size."

Increased concentration of corporate securities in a limited number of institutions has, in fact, had a major impact on securities markets. Given the extraordinary growth in managed pension plans since 1950, there has been a sizable increase in the volume and volatility of trading. Institutional investors as a group now hold about 35 percent of outstanding corporate stocks registered with the New York Stock Exchange but account for about 70 percent of total trading, up from 20 percent in 1960.[87] Pension funds are the largest and fastest growing segment within the group of institutional investors. At year-end 1984, they held 21 percent of outstanding U.S. stocks, 30 percent of U.S. corporate and foreign bonds, 15 percent of U.S. Government securities, and a variety of other financial assets.[88] Because their holdings are highly concentrated, they buy and sell individual stocks in large blocks, resulting in an increase in the volatility of prices and in the need for hedging activities.

A sizable portion of institutional trading in stocks is done by pension fund managers[89] who pursue short-term investment strategies even though pension funds represent long-term commitments of funds with relatively little requirement for liquidity. There is intense competition among the major managers to attract and retain clients but performance is based on quarterly or, at best, annual results. These short-term strategies suggest, again, that oligopoly may increase competition. Nevertheless, the overall result has been "a very poor level of performance for pension portfolios" with the rate of return on equity investments "lagging behind market averages such as the Standard and Poor Index".[90] Thus, some believe that the high level of competition among managers has tended to short-change ultimate beneficiaries.[91]

---

[87] New York Stock Exchange, *Fact Book*, 1983 and 1984, pp. 52, 54.

[88] Salomon Brothers, Inc., *1986 Prospects for Financial Markets*, tables 3, 3c, and 5. See Part II, Chapter 4 for further discussion of this and other concerns about the impact of the growth in pension fund assets on securities markets.

[89] It should be noted that equity investments of insurance companies are limited by state law. The largest life insurance companies are in New York and are subject to a 10 percent limit on holdings of common stock. However, insurance laws were revised in the 1960s to allow insurance companies to hold pension assets in "separate accounts" that could be invested in common stocks. Even so, pension funds managed by insurance companies hold fewer equities than bank-managed funds and about 25 percent of their assets are invested in mortgages compared with about 4 percent for banks (Alicia H. Munnell, *op. cit.*, pp. 21-22).

[90] *Ibid.*, p. 21. See also Randall Smith, "Teamsters Central States Pension Fund Fires Three Stock Managers, Shifts Assets", *The Wall Street Journal*, January 31, 1985, p. 6.

[91] Pension fund managers tend to respond to the objectives of plan sponsors which are based on actuarial assumptions rather than on achieving the highest rate of return over the long

Continued

As the level of both institutional and asset concentration implies, pension funds may favor some companies or sectors at the expense of others. Some believe that the "prudent man rule" mandated by the Employee Retirement Income Security Act (ERISA)—even under more liberal interpretation by the Labor Department which has encouraged venture capital investments—induces pension funds to invest in large, established companies whose shares can be readily bought and sold. From this perspective, many new and small companies do not now qualify for investment by pension fund managers who channel the fastest growing pool of resources into securities markets. Thus the institutionalization of the saving function—however beneficial in increasing saving and investment—has unintended effects on the allocative function of markets. And the concentration of these resources in a relatively small number of institutions exacerbates this problem by reducing the number of managers making investment decisions.

Implications of a link between financial consolidation and concentration

The argument for permitting financial institutions (or combinations of commercial and financial companies) to offer a diversified range of financial services rests on the assumption that consolidating these services within individual companies will increase the number of providers of services, increase competition and result in greater convenience and lower transactions costs for customers. That argument is less persuasive if the expansion of diversified financial companies results in a reduction in the number of individual decision-makers and an even greater concentration of financial resources than currently exists. While consolidating financial services within an individual institution will not increase concentration *per se*, such a result may occur in the absence of appropriate safeguards. And if consolidation does, in fact, increase concentration, the benefits of lower prices and convenience may appear as burdens if customers' options are reduced, and if lower transactions costs result from oligopolistic competition that reduces smaller customers' access to services and markets where price cutting necessitates a larger volume and scale of transactions to assure financial institutions' profitability.

An analysis of the potential for consolidation to increase or reduce the level of financial concentration must take into account the environment in which the services of individual institutions will be expanded and the costs of expansion. Even if authority for expansion were linked to *de novo* operations, the size of existing resources or the ability to raise new capital would determine an institution's capacity to expand services. Thus not all (particularly small) institutions would be able to take advantage of opportunities to engage in new activities. However, given that the capital ratios of almost all financial institutions and sectors are at historically

---

term. Because most large pension plans provide for defined benefits rather than defined contributions, a plan sponsor may be satisfied with a rate of return which would be less acceptable to the ultimate beneficiary of a defined contribution plan, particularly in a period of inflation. On the other hand, if a plan's sponsor can recapture excess funds, an opposite incentive exists: to raise the return. But, as discussed, most plan sponsors recapture funds by reducing next year's contributions. Thus they are primarily interested in short- rather than long-term gains.

low levels, it is more likely that a consolidation of financial services will increase the number of mergers and acquisitions and reduce the number of financial institutions.[92] And if consolidation does occur as a result of expansion through mergers and acquisitions, financial concentration will undoubtedly increase. The assets of very large institutions may rise while the total number of institutions shrinks and smaller institutions tend to disappear.

No one denies that breaking down the barriers between financial functions will tend to reduce the number of institutions. But the costs and benefits of financial concentration have barely been mentioned in current discussions of financial restructuring, and their implications for borrowers have been wholly ignored. This seems remarkable because some market participants have long believed that major banks are already so large they cannot be permitted to fail—a perception that was reinforced by the handling of the Continental Illinois crisis—and many analysts have called attention to this as a factor that inhibits an effective role for market forces in the regulatory process.[93]

But the assumption that large banks will not be permitted to fail also assumes that the government can prevent or manage the failure of large institutions. If, however, there is a consolidation of financial functions, problems may be more difficult to contain because different financial institutions are operating in more than one market. Given that an increase in interdependence between institutions and markets has already demonstrated the extent to which even relatively small failures can ripple through the system, it is likely that a further consolidation of institutions and functions could enlarge these ripple effects even without an increase in concentration.

Because current deregulatory proposals emphasize the role of market forces in balancing competition and soundness, ensuring that a consolidation of financial services does not increase concentration will be critical both in terms of preserving competition and soundness and enhancing the role of market forces. But implementing other deregulatory proposals may also require renewed emphasis on preventing excessive concentration to preserve these and other goals. For example, speaking of the potential for a rise in concentration posed by initiatives authorizing interstate banking, former FDIC Chairman Isaac said that "stronger antitrust laws" applying to banking will be required because:

> Making sure that there are plenty of alternative means of gaining access to credit is more important than making sure you have, say, plenty of choices of beer.[94]

Implicit in that statement by an advocate of deregulation is the view that a free market system is best served by a strong role for government in preventing over-concentration. The following statement by Professor Benjamin Friedman supports that view but voices as well the concerns of many that it may be very difficult to prevent concentration if financial functions are consolidated, and that a more concentrated and/or consolidated system could undermine the essential characteristics of a market system: its diversity, multiplicity and heterogeneity. In Dr. Friedman's view:

---

[92] For example, given differences in the capitalization of banks and securities firms, SEC Chairman Shad believes that authorization for banks to underwrite corporate securities could, in time, result in a significant reduction in the number of independent regional securities firms; *The FDIC Securities Proposal and Related Issues, op. cit.*, June 16, 1983, pp. 11, 47.

[93] William Jackson, "Public Rescue of Private Liabilities: The Continental Illinois Case", Congressional Research Service, Report No. 85-172E, November 20, 1985, pp. 23-24.

[94] Ronald Brownstein, "A Wall of Money", *National Journal*, July 30, 1983, p. 1603.

> Our market system works better than a centrally planned economy for the reason that it brings to bear lots of different viewpoints as well as the heterogeneity. What matters is people with different perspectives.
>
> One way to preserve that advantage is to have different institutions that differ among themselves not only because they are populated by different individuals but also because they serve different specific roles in the economy. That is what we do now. If we now move to a situation in which we have only a few all-purpose financial institutions, then the question is how different our system would be from some centrally planned economy. Of course, competition is very important. Even having two all-purpose financial institutions would still be different from having only one. Nevertheless, the reason why we would like to think our markets get us to the right place is that they have lots of people who know about different things taking part in the decisions. That is helped by having different categories of institutions as well as many different institutions.[95]

SUMMARY OF POLICY CONCERNS

In the past, structural and regulatory efforts to promote competition within the financial services industry have stressed the need to prevent impediments to competition that result from conflicts of interest, tie-ins and the concentration of financial resources. This is not the focus now. There is now a widespread belief and expectation that letting more institutions do different things will increase competition. Those who advocate "deregulation" as thus defined recognize that there is presently a less than desirable degree of competition. Many would agree with Stephen J. Friedman who argues that:

> It would not be desirable for Morgan Stanley, Salomon, Goldman Sachs and Merrill Lynch to each be acquired by a major bank. But it is hard to see why it would not be very pro-competitive for major banks to compete with those firms on a *de novo* basis.[96]

Such a view assumes that consolidating a number of financial services in a single institution will increase the number of providers of a given financial service. This may not be the outcome. "Unleashing competition" by expanding the range of activities in which a financial conglomerate can engage can only increase concentration and lessen competition if there is no effort to reduce the current high level of concentration in the financial services industry. Reliance on dismantling barriers between functions and products to increase competition also will fail if there is no effort to restrict conflicts of interest and tie-ins of services and effective regulatory efforts to enforce those restrictions.

---

[95] Statement of Professor Benjamin M. Friedman of Harvard University, *The Future of Financial Markets, op. cit.*, July 14, 1983, p. 248.

[96] Excerpt from a letter to the Subcommittee, June 5, 1985.

Increases in institutional and asset concentrations have been closely associated with recent changes in financial structure. The effects of concentration are apparent in the increasingly oligopolistic behavior of markets no longer confined to traditional securities products or the institutions that have traditionally underwritten or traded those products. Because concentration has already significantly reduced competition, it is clear that the old regulatory strategies intended to promote competition by preventing concentration have failed. But it is also clear that the goal of preventing concentration is no less valid than in the past.

Few would argue that increasing the number of existing institutions that offer a given financial service will increase the total number of institutions in the industry. Indeed, it is widely agreed that consolidating financial functions will tend to reduce the number of independent and smaller institutions. But the implications of such a development largely have been ignored. For the most part, proponents of "deregulation" in the sense used here assume that the existing regulatory structure will remain in place and that it is adequate to the task of preventing impediments to competition.

The analysis in this chapter suggests that existing regulatory strategies are not adequate to deal with a consolidated financial services industry. Moreover, in attempting to explore the broader implications of consolidation, it suggests that a deregulatory effort that takes this form may weaken competition and undermine the strengths of the market system itself. For example:

> The ability to integrate several financial functions within a single institution will tend to erode existing incentives for an arms-length evaluation of credit decisions and may result in a deterioration of credit quality that will increase the fragility of the financial system. Consolidation may also increase opportunities for self-dealing that could erode the impartiality of credit decisions, create additional competitive inequities involving both financial institutions and their customers, and result in asset concentrations in individual institutions that also contribute to systemic fragility. Opportunities for tie-ins will proliferate as financial services are consolidated. As the ability to package products and services grows, there may be a greater degree of homogeneity and less diversity in meeting capital and credit needs.

Consolidating financial functions will tend to increase concentration because of tie-ins and the fact that the ability to expand services either through mergers and acquisitions or *de novo* activities will depend on the size of institutions' existing resources or ability to raise capital. The expansion of institutions that are already very large, and/or mergers of a number of smaller institutions, will reduce the number of independent decision-makers in the system as well as the number of alternative sources of capital and credit. As a result, increased concentration could raise pressure for preferential treatment for some borrowing sectors that require more specialized services, and for a larger government role in credit allocation. At the same time, it may significantly weaken the government's role in protecting customers of financial institutions as the size of failures and their monetary and social costs rise.

Fewer institutions may result in increased volatility in secondary markets for traded assets. As the growth of institutional investors' share of securities markets indicates, the size of individual transactions will be larger if there is a significant reduction in the number of institutions, and their impact on markets greater. As purchases and sales increase in size, there could be wider and more rapid swings in price. The demand for opportunities and vehicles to offset the resulting increase in risk will rise even as the number of counterparts for hedging transactions contracts. In time, a trend toward fewer institutions could increase speculative activity and intensify the potential for "one-way" markets.

Several proposals have been offered to address some of the concerns raised by financial consolidation. They include prohibitions or limitations on cross-marketing of services offered by depository institutions holding companies that engage in other financial and/or commercial activities, extending existing bank holding company limitations on transactions with affiliates to include transactions with new affiliates formed as a result of authorization for expanded powers, and regulation of intra-company underwriting and cross-marketing involving securities firms and their nonsecurities affiliates. With respect to the relaxation of anti-concentration restraints on interstate banking, the House Banking Committee proposed restrictions on mergers between large institutions and limitations on the size of acquisitions in relation to the share of total domestic deposits held by banks.[97]

None of these proposals addresses all the concerns raised by the advent of the diversified financial conglomerate. And the additional proposal for functional regulation ignores the basic concern about diversification which is the dealings between the various components of the consolidated enterprise rather than the behavior of the individual unit engaged in a specialized function. Given the thrust of existing proposals, however, the broad policy options appear to be either to attempt to isolate the various activities by preventing all cross-marketing of products and services, and preventing or limiting financial transactions involving the parent holding company and/or affiliates, or to police dealings between affiliates to assure that they are conducted at arms-length and result in the same decisions with respect to price and credit-worthiness that the market would make.

Both of these options have drawbacks. The first will be strongly resisted by financial institutions because it limits opportunities for synergism and undermines the basic incentives for consolidation. The second would require a significant increase in regulatory surveillance and in the judgmental nature of regulatory evaluation, or else a substantial increase in the incidence of judicial review—none of which would contribute to market efficiency. But the concerns are real and strategies for dealing with them merit considerably more attention than they have received so far in the debate on financial restructuring.

---

[97] H.R. 2707 as reported by the Committee on June 18, 1985.

Meanwhile, the implications of consolidation for the conduct of monetary policy have been almost totally ignored in recent discussions of these issues. As both the market power of individual financial institutions and the interdependence of institutions and markets increase, the central bank's effectiveness as a stabilizing force may diminish. The size of its transactions relative to those of any one market participant will necessarily decrease. The Federal Reserve's open market transactions in government securities have, since the 1920s, constituted a powerful and efficient policy tool that can simultaneously influence the volume and price of bank credit and the availability and price of alternative credit instruments.[98] But the consolidation of financial functions may weaken its leverage. It is worth noting that in countries with more consolidated financial systems, central bank open market operations are either non-existent or are a far weaker policy tool.

The effectiveness of open market operations depends on their ability to influence a wide range of investors. Almost all U.S. financial institutions—in particular, banks, insurance companies and securities firms—and a wide range of non-financial investors (including individuals, businesses and state and local governments) buy and sell government securities. The segmentation of financial functions ensured that the effects of Federal Reserve operations in government securities would be felt in different asset markets. Consolidation may lessen their effect on individual markets and functions as institutions centralize investment transactions over a range of functions to achieve economies of scale and increase efficiency. But Fed policy operations could have a larger and more destabilizing impact on individual institutions that centralize transactions unless there is a greater degree of concentration. If, on the other hand, there is an increase in concentration, the individual institution may be somewhat insulated from Federal Reserve influence by virtue of its own market power.

Because a significant shrinkage in the number of institutions and a consolidation of their functions could erode monetary control and the ability of the central bank to serve as a back-up source of liquidity under current operating procedures, the most important policy concern that could emerge may be the viability of the monetary system itself. New tools and operating procedures may be required to restore the central bank's effectiveness in stabilizing markets and influencing the volume and price of credit. If open market operations become a less potent policy tool, it may be necessary to rely more heavily on reserve requirements and discount facilities and extend their coverage to include a wider range of financial institutions and instruments.

---

[98] Federal Reserve purchases and sales of government securities change the volume of reserves available to the banking system and thus influence the availability and price of bank credit. They also change the portfolio mix of other intermediaries and direct investors, making them more or less willing to hold private credit instruments. The Federal Reserve "eases" by buying government securities. This increases bank reserves. It also reduces the amount of governments in the portfolios of other intermediaries and investors, releasing funds to purchase private securities. The amount of credit extended to private borrowers rises and interest rates fall. Conversely, the Fed tightens by selling government securities and reducing the level of bank reserves. Other intermediaries and investors withdraw funds from private credit markets to purchase governments. The amount of credit extended to private borrowers falls and interest rates rise.

CHAPTER 4: PRESERVING THE ECONOMIC FUNCTIONS OF FINANCIAL MARKETS

INTRODUCTION: AN OVERVIEW OF FINANCIAL "MISSIONS"

The ultimate purpose of the framework for financial structure and regulation is to assist financial institutions and markets in performing their economic functions. The current focus on "competitive equity", "convenience" and raising returns to the "consumer" of financial services has tended to under-value or overlook the role that financial intermediation plays in an industrial society. Competitiveness, convenience, returns and even protection are irrelevant if the financial system fails to function as a dynamic catalyst in promoting economic growth. Unless the borrowers to whom savings and investment funds are channeled prosper, returns fall and intermediaries fail.

Of course, financial structure and regulation are not the only factors that contribute to insufficient returns on investment and financial failures. Macroeconomic policy is another factor in such scenarios. In the 1970s, for example, the rate of return from investments in U.S. stocks and bonds failed to keep pace with the rise in the rate of inflation. And the sharp rise in nominal interest rates due to the change in Federal Reserve monetary control procedures in 1979 precipitated a crisis situation for thrifts as returns on mortgages in their portfolios fell below the cost of funds and eroded their net worth. But throughout history, the failure of financial markets to assure that funds are productively employed has played a dramatic role in precipitating major economic dislocations. Notable examples include failures that resulted from financing foreign wars (e.g., the loans of Florentine bankers to English kings); failures and losses stemming from the tulip mania in Holland, the South Sea Bubble, the Great Crash of 1929 and excessive enthusiasm for lending to Latin America from the second half of the 19th century to the present.[1]

Financial structure and regulation cannot guarantee that mistakes will not be made. Managers of financial institutions have—and should have—a free hand in making credit and investment decisions. And even they cannot curb the speculative enthusiasm of direct investors if and when a mania mentality develops. Nevertheless, public policy can play a decisive role in moderating these tendencies before they happen by requiring that financial intermediaries meet their fiduciary responsibilities and that they perform their economic functions.

The structure of the U.S. financial system reflects a strong awareness of the economic functions of financial institutions and markets.[2] The decision to segregate functions and markets was intended to achieve the full range of regulatory goals that have been discussed in previous chapters. But it also recognized that different financing needs required different financial instruments and strategies. Thus, the 1930s legislation clarified the structure and "missions" of the various financial sectors to assure that intermediaries would perform their economic functions in allocating savings to productive uses. In particular, the role of commercial banks in providing short-term working capital to businesses, government and other financial sectors was clarified by limitations on their ability to make long-term corporate investments for their own accounts and on their mortgage lending. However, the need for a special financial sector whose mission was to finance housing was also recognized in 1934 with the creation of a national system for chartering and regulating saving and loan associations and insuring their deposits. Another financial innovation of the 1930s was the creation of a national system of credit unions to meet both the saving and borrowing needs of workers.[3] The reforms embodied in the Securities Acts of 1933 and 1934 recognized and strengthened the historic mission of capital markets as a source of long-term funds for capital formation. The "mission" of the insurance industry as both insurers and long-term investors had been debated and clarified in state law—particularly in New York—from the early years of this century through the 1920s, resulting in a separation between the business of life insurers and other financial and commercial activities.

---

[1] See Charles P. Kindleberger, *Manias, Panics, and Crashes: A History of Financial Crises*, New York, Basic Books, 1978.

A very significant but little discussed outcome of deregulation has been a distinct shift in the economic functions of the various financial sectors. In his 1984 Congressional testimony, Federal Reserve Chairman Paul Volcker noted, for example, that less than 10 percent of the funds of 47 percent of all commercial banks were invested in commercial loans [4]—a development that could be exacerbated by a proliferation of nonbank or "consumer" banks that elect not to make commercial loans in order to qualify for the loophole in current law. Meanwhile, as discussed, interest rate deregulation has shifted a significant share of housing finance from thrifts to the capital markets. And as a result of other deregulatory efforts, some thrifts are investing a larger share of their deposits in short-term money market instruments such as securities repurchase agreements and in some high yield bonds used to finance mergers, takeovers and leveraged buyouts. These changes in financial functions exacerbated the shift from long- to short-term financial investment and have significantly altered savings and credit flows. For example, the growth in mortgage-backed securities has increased the share of mortgage credit financed by traditional long-term investors (such as insurance companies and pension funds), contributing to a "crowding out" of long-term corporate borrowers in U.S. capital markets.[5]

---

[2] Professor James Tobin has described the economic functions of financial industries as including: "the pooling of risks and their allocation to those most able and willing to bear them, a generalized insurance function . . ." that "enables economic agencies to insure for themselves deliveries of goods and services in all future contingencies, either by surrendering some of their own resources now or by contracting to deliver them in specified future contingencies . . ."; "the facilitation of transactions by providing mechanisms and networks of payments; the mobilization of saving for investments in physical and human capital, domestic and foreign, private and public, and the allocation of saving to their more socially productive uses" ("On the Efficiency of the Financial System", Hirsch Memorial Lecture, New York, May 15, 1984, p. 4).

[3] To some extent, credit unions were promoted as a replacement for the postal savings system that had been phased out in the previous decade, and an extension of the industrial or "Morris Plan" banks that flourished in some established industrial centers. The U.S. postal savings system—like those in France and (until recently) in England—offered safety and convenience to small savers but was primarily a means for financing government rather than a source of loans for consumers.

[4] Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System as given before the Senate Banking, Housing and Urban Affairs Committee (reprinted in *Financial Restructuring: The Road Ahead, op. cit.*, p. 105).

As James Tobin observes: "The traditional role of commercial banks is to facilitate the circulation of funds among businesses, channeling the temporary seasonal and short-run surpluses of some businesses to those businesses with temporary deficits" (Tobin, *op. cit.*, p. 15). Clearly, the nonbank bank does not perform that role.

The success of the emerging secondary market for mortgage-backed securities has spurred new methods for securitizing credit including issues backed by automobile loans and bank loans. These innovations threaten to narrow even further the opportunities for corporations to raise funds for long-term investment. And other innovations in securities markets augment that danger. The scale of investment in derivative instruments such as futures, options and index products relative to investment in equity securities may indicate that a smaller share of savings and investment is being devoted to new issues.[6]

The market for new issues is the focal point for the economic function of capital markets. An expanding economy, generating new savings, should be expected to support an expansion of new long-term securities issues used to finance further economic growth. But the institutionalization of the savings function through the development of private and public pension funds has introduced a level of uncertainty in the performance of this traditional market function.

Investment in new securities issues involves an element of risk that historically has been rewarded by a higher rate of return. The emergence of institutional investors as the dominant force in securities markets has eroded this role. The emphasis in current law on their fiduciary obligation contrasts markedly with the profile of the typical investor of the past. The development of the airline, television and computer industries in the United States, for example, was made possible by securities investors who were willing to accept significant financial risk—speculating in an economic sense on the future prospects of new companies and technologies. The choice of index funds by a growing number of pension fund sponsors and managers is motivated by very different investment objectives: to ensure that their rate of return will match that of the market as a whole. In meeting these objectives, pension funds tend to invest heavily in outstanding stocks and bonds and in new issues of larger, established companies. As a result, the share of investment funds available to finance smaller or emerging companies may shrink.[7]

---

[5] While some thrifts are now investing in high yield, non-investment grade ("junk") bonds used for purposes other than mergers and acquisitions, stock buybacks and leveraged buyouts and, thus, are supplying net new funds to the corporate sector, their investments do not begin to offset the flow the other way—from corporate securities into mortgage-backed securities. Moreover, the shift reflects both a shift in the maturity structure of thrift assets (from 20-30 year mortgages to 8-9 year corporate debt) as well as a trend toward a fundamentally changed role for the thrift industry.

[6] For a more detailed discussion of this issue, see Tobin, *op. cit.*, pp. 13-15, 20-21.

As this introduction suggests, the focus of this chapter is on the mission of capital markets in providing funds for capital formation. Although deregulation has had important consequences in reshaping the economic functions of other financial sectors, it is beyond the scope of this report to examine developments across the financial services industry as a whole. But as securities markets have expanded to include a wider range of products and participants, any discussion of these markets inevitably includes sectors other than the securities industry.

The chapter begins with an examination of trends in U.S. corporate investment patterns. If there is validity in the assumption that macroeconomic policy and developments in financial markets influence the level of capital formation, these trends suggest that our national policies and markets have failed to meet their economic objectives. That section is followed by an analysis of developments in U.S. securities markets in the 1980s that demonstrates their failure "to provide, on a continuing basis, a significant net new source of capital for business . . ." [8]

The subsequent sections outline some of the changes in the structure of capital markets that may have altered their traditional function as sources of long-term funds for capital formation. The first discusses a structural change—discount brokerage—that resulted from legislation and regulations ending fixed commission rates on securities transactions in 1975. The next describes the enhanced role of institutional investors that resulted in part from the regulation of pension funds under the Employee Retirement Income Securities Act (ERISA) of 1974. This is followed by a discussion of the impact of an escalating dollar volume of hostile takeovers, the proliferation of innovative and derivative securities instruments and the growth of the secondary mortgage market in the aftermath of interest rate deregulation.

There are, obviously, many differences among these developments both in terms of their origins and effects. Nevertheless, there is a common theme in these discussions: structural change—whether initiated by regulation, deregulation or market forces—has important economic consequences. And this theme, in turn, supports the underlying thesis of this report: that decisions about the structure and regulation of financial institutions and markets must be made in the context of assessments of their economic impact; that preserving the economic functions of financial markets should be a primary objective of financial restructuring.

---

[7] While pension funds are an important source of venture capital, accounting for $360 million or 28 percent of total funds committed in 1984 (Jan Wong, "Venture Capital from Abroad Reaches Amount Rivaling Pension Funds Here", *The Wall Street Journal*, September 18, 1985, p. 40), the amount of funds allocated to fledgling entrepreneurs is small relative to annual increases in pension fund resources (in excess of $20 billion). Moreover, venture capital investments finance only a fraction of small U.S. companies and only those that have not yet "emerged" as public companies, that require ongoing financing for further expansion.

[8] Henry Kaufman, Executive Director, Salomon Brothers, Inc. "Dangers in the Rapid Growth of Debt: The Need for a National Policy Response," a talk delivered before the National Press Club, Washington, D.C., January 16, 1985, p. 5.

CAPITAL INVESTMENT TRENDS IN THE UNITED STATES

Because capital investment ultimately affects productivity, international competitiveness, economic growth, job creation and our standard of living, it is an important barometer of the overall health of the economy. The share of U.S. output devoted to investment has remained relatively constant over the last three decades; net private domestic investment has averaged around 7.2 percent of GNP. However, the share of national income devoted to net nonresidential fixed investment—that is, to capital formation rather than housing—fell below the levels of previous periods of recovery throughout the 1970s. In the early 1980s, rising Federal deficits and the recession acted to lower total net private investment from an average of 7.2 to 3.8 percent in 1981, 2.5 percent in 1982, and 1.9 percent in 1983.[9] As most analysts would agree:

> Large federal deficits must leave fewer resources available for domestic private investment unless there is a fully compensating increase in private domestic saving, in the budget surpluses of state and local governments, in the inflow of foreign savings, or in all of these together.[10]

TABLE 10.—NATIONAL INCOME AND NET FIXED NONRESIDENTIAL INVESTMENT

[Dollars in millions]

	Net fixed nonresidential investment	National income	Investment as a percent of income
1980	$77,032	$2,116,644	3.64
1981	90,596	2,363,837	3.83
1982	61,271	2,446,817	2.50
1983	49,762	2,646,741	1.88

Source: Survey of Current Business, July 1984, p. 75, 64; percent calculation by the Congressional Research Service (CRS).

The pace of economic activity and the availability and cost of capital are important influences on companies' investment decisions[11] that determine both the amount and composition of investment. The composition as well as the amount of investment in the United States has changed over the years. For example:

> During the inflationary 1970s, interest earned on surplus cash often failed to offset the decline in the purchasing power of the dollar. Companies that fared best plowed funds into land, buildings, machinery or other assets that were rising in price. But the 1980s may be different, these

---

[9] See Table 10.

[10] *The Economic and Budget Outlook: Fiscal Years 1986-1990—A Report to the Senate and House Committees on the Budget—Part I*, Congressional Budget Office, 1985 Annual Report, p. 84.

[11] Anne Swardson, "Depreciation Rules Under Fire Again", *The Washington Post*, February 24, 1985, p. G4.

This article reports that the National Association of Manufacturers conducted a survey of its members and found that "the pace of economic activity was the most important factor in companies' investment decisions. Second was the cost of capital, principally interest rates. Tax incentives placed third."

See also Barry P. Bosworth, "Taxes and the Investment Recovery", *Brookings Papers on Economic Activity*, 1 1985, for a detailed analysis of the relative unimportance of the 1981-82 tax reduction on the subsequent growth in investment spending.

> executives say, and interest yields from invested cash could exceed profits from most alternative investments.[12]

Moreover, there has been a shift in the distribution of total net investment from long-lived buildings and plants to shorter-lived equipment. There are several reasons for this trend:

> One is the tax system, which favors equipment over structures. (Most business equipment qualifies for the investment tax credit, but not structures.) Another reason may be the nature of new technology, especially computers which have very short economic lives. Finally, some economists believe that greater uncertainty in the economic situation has caused businesses to concentrate their investment dollar in projects that have quick returns.[13]

Concentration in shorter-lived assets has contributed to the rapid depreciation of capital in recent years. A growing portion of total capital investment in the U.S. is devoted to replacement of existing stock, rather than to investment in expansion and new production technologies. In the 1960s, about two thirds of total investment was directed toward replacing existing capital facilities. That share rose steadily during the 1970s so that, by 1981, the replacement share of capital outlays reached 80 percent.

These capital investment patterns coincide with a trend of steadily declining U.S. productivity. The growth of productivity in the United States from 1948 to 1969 was 2.3 percent annually. This growth rate fell to 0.7 during the period 1973 to 1981.[14] Reflecting the usual pattern in a recovery, it has picked up again, averaging 2.5 percent from 1982 to the present, but with an apparent slowdown in the last quarter of 1985. Although a number of factors influence productivity, there appears to be a strong relationship between investment rates and productivity growth. Japan has the highest investment and productivity rates; France and Germany each have higher investment and productivity growth rates than the United States, and the OECD average in 1984 was up 3.1 percent.

A key contributor to productivity growth is the amount of capital available per worker. Workers produce more output per hour with more equipment and with new technology. This all-important capital-labor ratio [15] grew at a rate of 3.3 percent in the 1950s, and then dropped to 2.0 percent in the 1960s and to 1.3 percent in the 1970s. Since 1980, the capital-labor ratio has risen to 2.8 percent—in part because 1980 was a low point in the business cycle and by 1983 the U.S. was fully into its recovery. Since there are an increasing number of Americans in the labor force, a larger percentage of GNP must be invested in plant and equipment to maintain or improve the capital-labor ratio and, hence, productivity.

---

[12] Ralph E. Winter, "Expecting Lean Times, Many Firms Try to Increase Efficiency", *Wall Street Journal*, November 28, 1983, p. 18.

[13] Congressional Budget Office, *op. cit.*, p. 10, footnote 4.

[14] Mary Jane Bolle, "Impact of the Business Cycle on Productivity Growth in the U.S." Economics Report #82-172E, October 19, 1982, Congressional Research Service, Library of Congress.

[15] Ratio of private, non-farm, business sector calculated through the least squares method by the Bureau of Labor Statistics, Office of Productivity and Technology, U.S. Department of Labor.

The high cost of capital has dampened investment in labor-saving equipment needed to improve productivity and reduce cost pressures. Since 1973, the cost of business investment has increased relative to the cost of labor by more than 20 percent. This trend is in contrast to the trend in the 1960s when the ratio declined by 27 percent as labor costs increased while capital costs remained stable. The rising cost of capital may lead many American corporate managers to focus on short-term objectives to minimize their payback schedules. It may also lead to a loss of competitiveness. For example, it is widely believed that "American firms must pay about three times as much for capital as do their Japanese competitors." [16]

These trends in capital investment have contributed to the decline in profitability of individual companies and affected their ability to raise adequate amounts of equity capital. The return on capital divided by the cost of capital services has declined sharply since 1974. The aggregate value of corporate equities dropped from 120 percent of net worth in 1968 to 50 percent in 1981.[17] This severe depression of equity values—despite the rebound from 1982 to the present—encouraged the dramatic rise in takeovers and acquisitions in the 1980s.

The failure of the equity market to provide adequate amounts of new capital increased companies' financial risk and exacerbated the decline in capital formation. For example, debt-equity ratios of manufacturing corporations have doubled since 1960. These high ratios impair companies' credit ratings, making it more difficult to obtain additional financing and boosting interest payment problems. Studies indicate that, as a result, a 10 percent increase in a company's debt-equity ratio leads to a 3 percent decrease in plant and equipment spending.[18]

Beginning with the recovery in 1983, corporate investment rose dramatically. In accounting for the recent change in investment, Roger Brinner, chief economist for Data Resources, Inc., estimates that:

> $25 billion of the $55 billion increase in real nonresidential fixed investment from the trough of the recession in late 1982 to the end of 1984 was attributable to the recovery of final spending. Another $15 billion was accounted for by tax-law changes, and about $7.5 billion came from the cost of funds.[19]

Barry Bosworth also argues that GNP growth was responsible for the recovery in investment. He notes that the concentration in investment demand in producers' durable equipment—and, even more narrowly, in office equipment and automobiles where the tax act did not change tax treatment [20]—"causes problems for an explanation of the growth in investment spending that emphasizes the 1981-82 tax reduction." [21]

---

[16] Paul E. Tsongas and George N. Hatsopoulos, "Cost of Capital Gives U.S. Competitive Disadvantage", *The Washington Post*, October 14, 1984, p. H2.

A special report on capital and long-term growth in *Business Week* cites Stephen Cohen, co-director of the Berkeley Roundtable on the International Economy at the University of California at Berkeley: "There are new businesses where Americans know they simply can't match Japanese competitors in terms of the cost of capital and the patience of capital." (Karen Pennar, "Is the Financial System Shortsighted?", *Business Week*, March 3, 1986, p. 82.)

[17] George N. Hatsopoulos, "High Cost of Capital: Handicap of American Industry" (a study sponsored jointly by the American Business Conference and Thermo Electron Corporation), April 26, 1983, p. 4.

[18] "The Financial Health of U.S. Corporations—Current Assessment and Future Prospects", the New York Stock Exchange, Office of Economic Research, March, 1983, p. 7.

[19] Swardson, *op. cit.*, p. 4.

However, as discussed below, an unprecedented volume of net new equity issues in 1983 also undoubtedly contributed to the upswing in corporate investment. The following section discusses the shifts in financial flows that have accompanied these trends in corporate investment. Whether caused by a decline in the demand for, or supply of, funds, it indicates that the decline in capital formation is clearly associated with developments in long-term capital markets.

DEVELOPMENTS IN U.S. CAPITAL AND CREDIT MARKETS

U.S. credit market debt—the result of borrowing by the Federal and state and local governments, all business sectors and consumers—has risen ten-fold over the last quarter century. In 1960, total outstanding debt was $700 billion. Ten years ago, it was $2.4 trillion. By year-end 1985, it had risen to $6.9 trillion (see Table 11). Actually it is much larger. The $6.9 trillion figure excludes a number of instruments and transactions that are unrecorded but which, like recorded debt, have ballooned in the last decade.[22] What is disturbing about this increase in debt is that, as one observer notes, it "is increasing more rapidly than is nominal gross national product" and a "pronounced widening in this gap has occurred within the past five years." [23]

---

[20] Except in the case of computers where the tax act increased the tax rate (Bosworth, *op. cit.*, p. 4).

[21] *Ibid.*, pp. 3-4.

[22] Kaufman, *op. cit.*, pp. 2-3.

"Hidden debt" for which aggregate data are not available includes futures, options, interest rate swaps, currency swaps, credit guarantees by banks and insurance companies, and firm lines of credit (*Ibid.*, p. 3).

[23] *Ibid.*, p. 3.

TABLE 11: Funds Raised in U.S. Financial Markets
(In billions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985*	Amt Outstanding 12/31/85*
Borrowing Sector									
Government	119.0	104.0	134.1	137.4	263.7	282.8	315.8	364.5	2,829.3
U.S. Treasury	46.9	31.9	75.5	77.8	152.3	174.8	188.9	185.3	1,394.3
Federal Agencies	39.6	44.3	43.2	45.3	62.1	67.9	72.1	99.7	820.6
State & Local	32.5	27.8	15.4	14.2	48.4	40.1	54.7	79.5	614.4
U.S. Business	122.4	129.8	108.1	147.7	104.6	102.1	225.5	164.3	1,807.4
Long-term bonds	30.2	31.8	38.6	30.4	48.0	46.2	80.8	94.8	719.0
Short-term borrowing	92.2	98.0	69.5	117.3	56.6	55.9	144.7	69.5	1,088.4
Foreign Bonds	4.2	3.9	0.8	5.4	6.7	3.8	4.1	5.3	73.0
Households	170.1	162.4	88.2	101.3	40.4	159.3	244.5	211.4	2,384.4
Mortgages**	117.7	113.1	78.6	68.0	14.7	90.0	140.3	91.9	1,547.3
Short-term borrowing	52.4	49.3	9.6	33.3	25.7	69.3	104.2	119.5	837.1
Total Private	296.7	296.1	197.1	254.4	151.7	265.2	474.1	381.0	4,264.8
TOTAL RAISED***	415.7	400.0	331.2	392.5	415.4	548.0	789.9	745.5	6,894.2
Memo items:									
Private Long-term	152.1	148.8	118.0	103.8	69.4	140.0	225.2	192.0	2,339.3
Private Short-term	144.6	147.3	69.5	150.6	82.3	125.2	248.9	189.0	1,925.5
Net Equity Issues	-1.4	-1.9	11.6	-23.5	-20.3	25.8	-82.8	-62.8	2,378.2

* = Estimated
** = Privately Held
*** = Excludes equities

Totals may not sum due to rounding

Source: Salomon Brothers Inc., Prospects for Financial Markets, 1984, 1985 & 1986,
Various Tables (as compiled by Subcommittee Staff)

TABLE 11a: Percentage of Total Credit Absorbed by Various Sectors

Borrowing Sector	1978	1979	1980	1981	1982	1983	1984	1985*	% of Outstanding Credit: 12/31/85*
Government	28.6	26.0	40.5	35.0	63.5	51.6	40.0	48.9	38.1
U.S. Treasury	11.3	8.0	22.8	19.9	36.7	31.9	23.9	24.8	20.2
Federal Agencies	9.5	11.0	13.0	11.5	15.0	12.4	9.1	13.4	9.0
State & Local	7.8	7.0	4.7	3.6	11.9	7.3	6.9	10.7	8.9
U.S. Business	29.5	32.4	32.8	37.6	25.2	18.6	28.5	22.0	26.2
Long-Term bonds	7.3	7.9	11.7	7.8	11.6	8.4	10.2	12.7	10.4
Short-term borrowing	22.2	24.5	21.0	29.9	13.6	10.2	18.3	9.3	15.8
Foreign Bonds	1.0	1.0	0.2	1.4	1.6	0.7	0.5	0.7	1.1
Households	40.9	40.6	26.6	25.8	9.7	29.1	31.0	28.4	34.6
Mortgages	28.3	28.3	23.7	17.3	3.5	16.4	17.8	12.3	22.4
Short-term borrowing	12.6	12.3	2.9	8.5	6.2	12.7	13.2	16.0	12.1
Total Private	71.4	74.0	59.5	64.8	36.5	48.4	60.0	51.1	61.9
TOTAL RAISED**	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo items:									
Private Long-term	36.6	37.2	35.6	26.5	16.7	25.6	28.5	25.8	33.9
Private Short-term	34.8	36.8	21.0	38.4	19.8	22.9	31.5	25.4	27.9

* = Estimated
** = Excludes Equities

Totals may not sum due to rounding

Source: Salomon Brothers Inc., Prospects for Financial Markets, 1984, 1985 & 1986, Various tables (as compiled by Subcommittee Staff)

TABLE 12: Funds Supplied in U.S. Credit Markets
(In billions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985*	Amt Outstanding Dec 31, 1985*
Sources of Funds									
Depository Institutions	198.9	178.7	155.4	134.7	138.7	280.6	335.0	240.0	3,168.7
Thrifts	72.8	56.5	54.1	27.2	31.5	142.1	147.3	91.0	1,239.1
Commercial Banks	126.1	122.2	101.3	107.5	107.2	138.5	187.7	149.0	1,929.6
Insurance, Pensions, Endowments	72.4	77.9	88.4	90.7	104.2	95.3	126.7	125.2	1,358.8
Other Financial	29.3	57.1	28.6	95.6	60.0	24.6	125.4	136.6	719.7
Households:									
Direct Investment	61.8	76.9	39.6	43.0	73.0	75.7	125.2	165.4	1,014.7
Other NonFinancial	15.1	14.1	-1.1	14.0	25.1	46.1	43.4	44.7	316.3
Foreign Investors	38.0	-4.6	20.2	14.4	14.4	25.8	34.2	33.4	315.8
TOTAL SUPPLIED**	415.7	400.0	331.2	392.5	415.4	548.0	789.9	745.5	6,894.2
Memo items:									
Total Domestic Financial	300.6	313.7	272.4	321.0	302.9	400.5	587.1	501.8	5,247.2
Total Domestic Nonfinancial	76.9	91.0	38.5	57.0	98.1	121.8	168.6	210.1	1,331.0

* = Estimated
** = Excludes Equities

Totals may not sum due to rounding

Source: Salomon Brothers Inc., Prospects for Financial Markets, 1984, 1985 & 1986, Table 1(as compiled by Subcommittee Staff)

261

TABLE 12a: Percentage of Total Funds Supplied by Various Sources

Sources of Funds	1978	1979	1980	1981	1982	1983	1984	1985*	% Outstanding Funds Supplied Dec 31, 1985*
Depository Institutions	47.8	44.7	46.9	34.3	33.4	51.2	42.4	32.2	46.0
Thrifts	17.5	14.1	16.3	6.9	7.6	25.9	18.7	12.2	18.0
Commercial Banks	30.3	30.6	30.6	27.4	25.8	2[illegible].3	23.8	20.0	28.0
Insurance, Pensions, Endowments	17.4	19.5	26.7	23.1	25.1	17.4	16.0	16.8	19.7
Other Financial	7.1	14.3	8.6	24.4	14.4	4.5	15.9	18.3	10.4
Households: Direct Investment	14.9	19.2	12.0	11.0	17.8	13.8	15.9	22.2	14.7
Other Nonfinancial	3.6	3.5	-0.03	3.6	6.0	8.4	5.5	6.0	4.6
Foreign Investors	9.2	-1.2	6.1	3.7	3.5	4.7	4.3	4.5	4.6
TOTAL SUPPLIED**	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memo Items:									
Total Domestic Financial	72.3	78.4	82.2	81.8	72.9	73.1	74.3	67.3	76.1
Total Domestic Nonfinancial	18.5	22.8	11.9	14.6	23.8	22.2	21.4	28.2	19.3

* = Estimated

** = Excludes Equities

Totals may not sum due to rounding

Source: Salomon Brothers Inc., Prospects for Financial Markets, 1984, 1985, & 1986, Table 1 (as compiled by Subcommittee Staff)

Some of the explosion in debt occurred in the late 1970s as credit expanded to finance rising nominal GNP. In the years 1979 through 1982, annual credit flows, in annual dollars, fell to below the level of 1978 and only rebounded to that level in 1981. As a result of two back-to-back recessions, credit flows to the private sector fell significantly in those years while government borrowing rose (See Table 11). But there has been a more gradual shift in the composition of debt since the mid-1970s. Government debt grew 15.7 percent annually over the five year period from 1979 through 1984, compared with a 2.0 percent annual growth rate in the 1960s, 4.6 percent from 1970 to 1974 and 13.1 percent from 1975 to 1978.[24]

The impact of macroeconomic policy and interest rate ceilings

Tables 11 and 12 show the more recent impact of macroeconomic policy on credit markets. The sharp rise in U.S. Treasury borrowing in 1982 reflects a highly stimulative fiscal policy resulting from tax cuts and increased reliance on deficit financing in lieu of a significant reduction in overall spending. On the other hand, the decline in total credit market borrowing reflects the offsetting impact of monetary restraint. Obviously, the burden of monetary restraint fell most heavily on the private sector. The Treasury and Federal agencies met their credit needs—albeit at a price—while the private sector had to curtail its needs as well as pay a higher price for credit in real terms. In real terms, the level of borrowing by households and businesses remained significantly below their respective borrowing levels in 1978 through 1983.

As Tables 12 and 12a suggest, monetary restraint impacted on financial institutions as well as private borrowers. Total lending stagnated after 1978 until Federal Reserve easing initiatives took effect in 1983 together with an increase in inflows of foreign funds. Like nonfinancial businesses, the financial sector experienced lower revenues and profits in the period 1979 through 1982. In the case of thrifts, whose share in credit flows dropped sharply over a four year period and, in 1981 and 1982, was less than half the level of 1978, the impact of sustained monetary restraint precipitated a crisis.

The experience of thrifts and mortgage markets—particularly in 1982 when mortgage credit fell to $14.7 billion compared with $117.7 billion raised in 1978 (see Table 11)—was also affected by regulatory restraints. Interest rate ceilings on deposits resulted in a diversion of funds from thrifts to nondepository financial intermediaries such as money market mutual funds (MMMFs).[25] That shift is clearly reflected in the data on funds supplied by other financial institutions in 1981 (See Tables 12 and 12a) but less clearly shown in the data for 1982 as funds supplied by nonbank intermediaries other than MMMFs declined and MMMFs invested a larger share of their funds in foreign financial markets.

---

[24] *Ibid.*, p. 3.

[25] The data in Tables 12 and 12a show a pattern of declines in total commercial bank lending that suggests they experienced little or no outflow as a result of interest rate ceilings. However, these data do not indicate the difference in the experiences of large and small banks. Large banks not only had access to the Euromarkets but were also able to recapture some of the funds shifted to MMMFs that were invested in large CDs. Small banks, on the other hand, experienced significant net outflows of funds.

Short-term consumer borrowing also fell in this period as a result of both monetary restraint and regulatory restraints on interest rates—in this case, usury ceilings on loans that, in some states, remained below market rates of interest until preempted by Federal law. The sharp drop in 1980, however, primarily reflects the Carter Administration's credit control program. But short-term consumer borrowing rebounded sharply in 1983—again, the result of Federal Reserve easing and an unprecedented inflow of foreign funds associated with the rise in the value of the dollar [26]—and rose rapidly in 1984 and 1985. Measures of this sector's indebtedness—the ratios of household debt to net worth and disposable income—rose to record highs of 19 percent and 84 percent, respectively, at year-end 1985.[27]

Short-term borrowing and variable interest rates

A shift to short-term financing by the private sector was apparent in the 1970s but became even more pronounced in the 1980s (see Tables 11 and 11a). This is particularly true for the business sector. For example, the ratio of net new bond and stock issues to total corporate external financing was 44 percent in 1980 and 27 percent in 1981 compared with 94 and 50 percent in 1975 and 1976 respectively.[28] In 1983-1984, the ratio was 48 percent.[29] As these figures suggest, in the past corporations have been able to issue long-term obligations to repay short-term debt at the beginning of a business expansion. Because they were unable to do so in 1980 and 1981, "the ratio of long-term to short-term debt hit a record 2.4 to one at mid-year 1981, and the ratio of liquid assets to short-market debt fell to an unprecedented low of 0.6 to one." [30] By 1983, it was evident that rebuilding corporate liquidity to the point where the ratio matched its previous peak in 1976 "would require a staggering $203 billion of long-term capital by the end of 1984" [31]—and equally evident by the end of 1984 that a reversal in the "ongoing deterioration" of the credit structure of U.S. business corporations had not taken place.[32]

But even these figures fail to reveal the full extent of the problem. Data on corporate bond issues are deceptive. For example, the proportion of medium-term securities to long-term securities for corporate issuers rose from 20 percent in 1978 to 40 percent in 1981,[33] was significantly higher in 1984, and lower in 1985. But at the beginning of the 1980s, this meant a shift downward from 20-30 year to 10-15 year maturities. Now the average maturity of corporate bond issues is even shorter as businesses have come to rely more on variable rate notes. The U.S. Treasury—which issued $35 billion of long-term bonds in 1984—is practically the only borrower that can get 20-30 year money at fixed rates of interest.[34]

---

[26] Total foreign investment in the U.S. was $83.1 billion in 1984 but a substantial amount of foreign short-term investment—perhaps as much as $22 billion in the first nine months of 1984—escapes reporting procedures and does not appear in the data reported in Table 12. Nevertheless, there is also evidence of the magnitude of changes in international investment flows involving other countries. For example, net investment in non-Japanese securities by Japanese investors soared from $4 billion in 1980 to approximately $27 billion in 1984. As A. Richard Janiak of Smith Barney Harris Upham International Inc. noted: "Just as they have been dominant exporters of automobiles, the Japanese are emerging as a major source of capital." (David A. Vise, "Japan Now Exporting Capital", *The Washington Post*, February 23, 1985, p. 7).

Meanwhile, a decline in U.S. investment abroad—to $1.8 billion in 1984 from $43.3 billion in 1983 and $107.8 billion in 1982—also contributed to the largest rise in domestic nonfinancial debt on record in the postwar period and to dollar appreciation ("U.S. Investors Slash Foreign Portfolios As Domestic Vigor Lures Back Dollars", *Wall Street Journal*, February 25, 1985, p. 58.

[27] Salomon Brothers, Inc., *Prospects for Financial Markets in 1986*, December 18, 1985, p. 14.

[28] Eduardo G. Mestre, Vice President for International Corporate Finance, Salomon Brothers, Inc., "New Trends in the United States Capital Market", *Capital Markets Under Inflation*, edited by Nicholas Bruck, Stock Exchange of Buenos Aires in cooperation with the inter-American Development Bank, Washington, D.C., 1982, p. 107.

[29] Kaufman, *op. cit.*, p. 4.

[30] Mestre, *op., cit.*, p. 107.

[31] Goldman Sachs, "Financial Market Perspectives", June 1983, p. 3. (Reprinted in *Future of Financial Markets*, *op. cit.*, p. 196).

[32] Kaufman, *op. cit.*, p. 4.

Increased reliance on floating rate financing has an effect on borrowers similar to that of borrowing short: the long-term cost of capital is unknown. And the use of floating interest rates on longer term credits has increased markedly. For business borrowers, who have a longer experience with floating rate short-term bank credit, floating rate notes and puttable obligations accounted for $16 billion or 38 percent of the gross issuance of corporate bonds in 1984, up from $6 billion or 18 percent in 1983.[35] The reaction of corporate borrowers to changing markets and uncertainty is reflected in the proliferation of interest rate swaps, zero coupon bonds and other innovative financing strategies. Meanwhile, three-fourths of all mortgages issued by savings and loan associations carried adjustable rates in 1984.[36] State and local governments, too, are financing with floating rates and lower maturities. In 1984, they issued $25 billion (26 percent of gross new municipal bond issues) of puttables, up from $5.6 billion (7 percent of gross new issues) in 1983.[37] Thus, "the private borrower, who can least withstand upward leaps in interest rates, has become a greater risk taker, while the U.S. Treasury, the most credit worthy, has usurped the long- term fixed-rate market".[38]

Declining liquidity and increased risk

For private borrowers, the overall results of developments in U.S. credit markets have been a decline in liquidity and an increase in risk. The position of financial intermediaries mirrors these results. They, too, are highly leveraged by historical standards and faced with the risks posed by a deterioration in credit quality that has been the consequence of both the upward surge in debt and the downward pressure on its maturity. As discussed, regulators are pressing depository institutions to raise capital ratios as a means of protecting the banking system against a higher level of credit risk. But the problem of overleveraging on the part of their borrowers may be so large and so widespread that raising the capital ratios of lenders will offer very little protection. It will, however, reduce their ability to lend and thus, in time, will also slow the rise in debt—particularly since their performance in the equity market does not suggest that depository institutions will find it easy to raise capital.

---

[33] Mestre, *op. cit.*, p. 107.

[34] Kaufman, *op. cit.*, p. 5.

[35] *Ibid.*, p. 4.

Puttables are obligations that, in many cases, can be sold back to the issuer on a demand or seven-day basis.

[36] Remarks prepared for delivery by Edwin J. Gray, Chairman, Federal Home Loan Bank Board, before the Annual Economic Conference, Federal Home Loan Bank of San Francisco, San Francisco, California, December 11, 1984, p. 1.

[37] Kaufman, *op. cit.*, p. 5.

[38] *Ibid.*, p. 5.

Developments in the equity market

The performance of the equity market has been a key factor in eroding the liquidity of the business sector and its overall financial health. After 1972, when gross new issuance of common and preferred stocks was $14.08 billion, gross new issues averaged around $10 billion on an annual basis for the rest of the decade.[39] Gross annual issues rose in the 1980s but the volume of net issues was depressed by retirements due to a significant increase in the dollar volume of mergers, leveraged buyouts and stock repurchases. In 1984 and 1985, for example, the scale of merger activity resulted in a $146 billion contraction in the total value of outstanding equities.[40] Thus, despite a record volume of new issues in 1983 and another good year in 1985, stock buybacks, mergers and leveraged buyouts financed by debt substantially increased the leverage of the corporate sector. On a book value basis, equity as a percent of total capitalization "reached a record low of 57.9 percent at the end of 1982, down from nearly 70 percent 30 years ago." [41] Projections for 1986 suggest that this trend will not be reversed in the near future.

This "ominous development"—"the recent failure of the equity market to provide, on a continuing basis, a significant net new source of capital for business and the virtual disappearance of a market for long-term bonds issued by private borrowers" [42]—is the primary concern and focus for this chapter. The macroeconomic factors that have contributed to this failure—inflation in the 1970s; monetary restraint and burgeoning Treasury deficits in the 1980s—are widely recognized and have been sketched out above and in other sections of this report. But the ways in which financial markets have adapted to these developments have resulted in some important structural changes. And these changes themselves may now contribute to perpetuating the uncertainty and volatility to which they were intended to respond.

CHANGES IN THE STRUCTURE AND ECONOMIC FUNCTIONS OF CAPITAL MARKETS

Discount brokerage

The termination of fixed commissions on securities transactions in May 1975 led to an unbundling of services offered by securities firms.[43] One of the more important innovations stemming from this development was discount brokerage. The major difference between discounters and traditional brokers is that discounters charge lower commissions and do not offer investment advice. Many discount brokers offer most of the same investment choices as traditional brokers—corporate equities and bonds, money funds, government and municipal bonds, IRAs and Keogh accounts, tax shelters, options, financial futures and commodities—as well as SIPC protection, free safekeeping facilities, interest on cash in the account, monthly statements, and individual trade confirmations. Some discounters also offer such services as integrated cash-management accounts, additional insurance over SIPC coverage (up to $2 million or more), and dividend payment and reinvestment.[44]

---

[39] *Economic Report of the President,* transmitted to the Congress, February 1985, p. 335.

[40] See memo item on Table 11 and Table 13. It is estimated that by year-end 1986, about $200 billion, or 10 percent of outstanding corporate stock, will have been retired.

[41] Goldman Sachs, *op. cit.,* p. 1 (*Future of Financial Markets, op. cit.,* p. 192).

[42] Kaufman, *op. cit.,* p. 5.

[43] The end of fixed commission rates after May 1, 1975 was a requirement of the SEC's Rule 19b-3 (SEC Release No. 34-11203, 1/23/75). A similar provision was mandated by Congress in P.L. 94-29 (June 4, 1975), the Securities Acts Amendments of 1975 (Kevin F. Winch, *Discount Brokerage of Securities: A Status Report,* Congressional Research Service, Report No. 84-32E, March 12, 1984, p. 7).

Because discount brokerage is understood to mean the execution of buy and sell orders for securities (including those that banks are not allowed to buy and sell for their own accounts) initiated by customers, it is interpreted to be similar to services permitted for banks under the Glass-Steagall Act and therefore permissible for banks.[45] The discount broker—whether wholesale (executing transactions for institutions) or retail (executing transactions for individuals)—does not recommend purchases or sales of particular securities. Because the Glass-Steagall Act prohibits banks from offering investment advice in association with brokerage activities, a discount broker affiliated with a member bank (or discount brokerage offered directly by a bank) would be in violation of Glass-Steagall if advice were offered. Therefore, as more banks engage in discount brokerage, it might be expected that securities firms will tend to conform to this norm to meet competition in price. In practice, however, the demand for advice from retail customers has encouraged discount brokers affiliated with both banks and securities firms to offer "third party" advice—usually in the form of brief descriptions of market developments and recommendations for purchases and sales of specific stocks prepared by rating agencies and similar entities.[46]

Whether or not discount brokers affiliated with banks are in violation of Glass-Steagall in offering third party investment advice is an issue that has not been settled. However, the fact that discount brokers do not advise customers on particular securities may result in increased risk. For example, customers may be unaware of the risks involved in purchasing options, financial futures and commodities which are offered by many discount brokers.

Concerns about the appropriate levels of risk for individual investors is reflected in the emphasis in securities laws and regulations on assuring that advice about purchases of particular securities is suitable in terms of an investor's income or investment objectives. Requirements that securities firms meet "suitability" standards are part of the larger concern for maintaining investor confidence in the markets and are consistent with the fiduciary responsibilities imposed on bank trust departments and pension fund managers. Clearly discount brokerage diminishes the traditional role of securities firms in offering advice. While that may lower costs, it may also undermine benefits. To the extent that it precludes the dissemination of adequate information to individual investors, the growth of discount brokerage may increase the risk of their participation in securities markets and undermine confidence in the markets.

---

[44] *Ibid.*, pp. 4-5.

[45] See Part III, Chapter 1 for a discussion of regulatory disparities resulting from banks' discount brokerage activities.

[46] Joe Kolinan, "Discounters on the March", *Institutional Investor*, February 1985, pp. 178-179.

Discount brokerage may also tend to divorce the underwriting and distribution functions of securities firms. Independent discount brokers and those affiliated with depository institutions are obviously not involved in underwriting. But these are the discount brokers that compete primarily with full service, regional securities firms that depend heavily on retail services for earnings. As discounters continue to gain market share,[47] they may undermine the profitability of regional firms and thus slow the rate of increase in their capital positions—a critical factor in maintaining their ability to participate in underwriting syndicates and in distributing new issues to individuals and regional institutional investors.

But the advent of discount brokerage also impacts on the operations of the larger, national securities firms. As discussed in the previous chapter, lower commissions on securities transactions—particularly for large institutional investors—resulted in increased competition among securities firms that slowed the growth of capital contributions from profits, contributed to a shake-out in the industry and increased concentration, especially in underwriting.[48] Lower profits on transactions have encouraged a trend among the larger firms toward "wholesale" brokerage—e.g., increased reliance on a greater volume of transactions to make up for a narrower margin of profit. This trend has been fueled by the lower transactions costs that enable (and encourage) a high rate of turnover in the portfolios of major institutional investors.[49] And as the trend becomes more prevalent, the retail operations of the major firms may atrophy as well, further undermining the historic link between the new issues market and the individual investor.

It is argued that discount brokerage indirectly benefits the new issues market because lower transactions costs encourage individual investor participation and thus add to the liquidity of secondary markets. However, as shown in Table 13 below, there has been a significant decline in the value of shares owned by individual investors in the 1980s, and a significant increase in the value of shares owned by institutional investors. Whatever the causes of these developments, it is clear that the advent of discount brokerage has not been a potent factor in stemming the decline in stock ownership by individual investors. And, as discussed below, because their fiduciary responsibility discourages risk-taking, institutional investors are less likely than individual investors to finance small or emerging companies and industries, and thus less likely to contribute to the economic innovation that results from the commercialization of new technologies.

---

[47] Discount brokerage firms are attracting 35 to 40 percent of all new retail customers entering the market and their share of retail trades jumped to 20 percent in 1984 from 12 percent in 1983 (*Ibid.*, p. 177.)

[48] As discussed in the previous chapter, the SEC's authorization of shelf registration (Reg. C, Rule 415, SEC Rls. No. 33-6499, 11/17/83) is also widely believed to have contributed to a concentration in underwriting.

[49] Tobin quotes John Maynard Keynes as advocating during the Great Depression a "substantial" transfer tax on securities "with a view of mitigating the predominance of speculation over enterprise in the United States" (Tobin, *op. cit.*, p. 10) and concludes: "I suspect that Keynes was right to suggest that we should provide greater deterrents to transient holdings of financial instruments and larger rewards for long-term investment" (*Ibid.*, p. 21).

This suggests that, at best, the contributions of discount brokerage to enhancing the economic functions of capital markets have been less than substantial. However, discount operations may adversely affect the performance of new issues markets for the stocks of all but the largest, established companies if only because the cost of disseminating information about particular securities may rise as the breadth and quality of coverage declines.

In summary, there is no clear-cut evidence that discount brokerage has an adverse impact on the market for new issues. But there are indications that discount brokerage has changed the structure of the distribution system for new issues, and the way this change will affect the market for those issues is equally unclear. While it is argued that discount brokerage benefits the new issues market by adding to the liquidity of secondary markets and encouraging continued individual investor participation in those markets, the data suggest that the growth in discount brokerage reflects a redistribution of market shares rather than an expansion of the retail market. In any event, the economic function of discount brokerage should be evaluated in terms of its benefits to those who raise funds in capital markets as well as its benefits to intermediaries and investors.

The role of institutional investors

Institutional investors now hold 35 percent of outstanding U.S. corporate stocks, 78 percent of outstanding U.S. corporate and U.S.-issued foreign bonds and 44 percent of outstanding Treasury debt.[50] They account for over 70 percent of trading on the New York Stock Exchange, up from 20 percent in 1960.[51] As their share in NYSE trading suggests, the shift in control of shares from individual direct investors to a smaller number of institutional decision-makers has increased the volatility of the equity markets. In fact, the large size of transactions by institutional investors—*i.e.*, purchases or sales of large blocks of a given stock or corporate or government bonds--contributes to wider swings in prices for all traded assets. The annualized daily price change of long-term Government securities was 11 percent in 1984, for example, two-thirds greater than the same measure of volatility in the 1970s.[52]

Pension funds are the largest and fastest growing segment within the group of institutional investors. At year-end 1985, they held 21 percent of outstanding U.S. stocks, 28 percent of outstanding U.S. corporate and foreign bonds, 15 percent of U.S. Government securities and a variety of other U.S. and foreign financial assets.[53] While there was a high level of growth in their holdings in the 1950s when many companies joined industry leaders such as General Motors in forming pension plans, much of the recent growth reflects the impact of the ERISA requirement that pension plans be adequately funded. This requirement led to a higher level of capital formation in the 1970s than would otherwise have taken place because it mandated an increase in purchases of assets by pension funds and, in that period, their acquisitions were primarily long-term corporate bonds and stocks.[54]

---

[50] Salomon Brothers *Prospects for Financial Markets in 1986* tables 3, 3c and 5

Institutional investors include life and property-casualty insurance companies, private noninsured pension funds and state and local retirement funds, foundations and endowments, stock mutual funds, security brokers and dealers and mutual savings banks. Commercial banks also hold small amounts of corporate bonds ($23.2 billion at year-end 1985) but do not hold corporate stocks for their own accounts. Holdings by their trust departments are included in data on individual holdings. (Thus institutional investors' control over purchases and sales of stock is greater than these data suggest.) Treasury securities held by commercial banks and thrifts for their own accounts are included in data for institutional investors but holdings in trust accounts are not.

[51] New York Stock Exchange, *Fact Book*, 1983 and 1984, p. 57.

[52] Kaufman, *op. cit.*, p. 7.

Interest rate volatility due to Federal Reserve monetary control procedures contributes to this result as well. It is well known that monetary targeting requires loss of control over nominal interest rates.

As an ever larger share of U.S. saving was channeled into pension funds, opportunities for greater efficiency in channeling funds to securities issuers increased. On the other hand, the fiduciary responsibility imposed on pension fund managers under ERISA may be in conflict with investment strategies that promote the economic functions of corporate securities markets. Traditionally, the economic functions of these markets in providing funds for capital formation assumes long-term investment strategies on the part of both investors and issuers intended to assure returns over time, that may, however, involve a significant amount of risk. But the fiduciary responsibility of pension fund managers implies a different investment strategy: achieving the maximum return for beneficiaries with minimal risk.

Most of the strategies of securities regulation—disclosure and due diligence, for example—also are based on the assumption that investments in securities are risky.[55] Moreover, they assume that the majority of investors are individuals. However, certain disclosure and other requirements under Federal securities laws recognize the distinction between small, "unsophisticated" investors, and investors who are considered to be better informed and better able to support risk.

While individuals still own the major share of stocks (60 percent),[56] a significant portion of their holdings are in trust accounts managed by commercial banks.[57] The fiduciary responsibilities of trust fund managers are like those of pension fund managers and they, too, choose investment strategies that involve minimal risk.

---

[53] Salomon Brothers, Inc., *op. cit.*, tables 3, 3c and 5.

[54] Statement of Benjamin Friedman. *Future of Financial Markets, op. cit.*, July 14, 1983, p. 256.

[55] As James Tobin noted: "Capital markets enable fundamental risks of business enterprise to be taken by the adventurous, while risk-avertors content with lower average returns are protected from many possible sources of loss." (Tobin, *op. cit.*, p. 11.)

[56] See Table 13 below.

[57] At year-end 1980, stockholdings of personal trust funds were valued at $132.9 billion or 8.4 percent of the market value of total stock outstanding ($1,573.3 billion) or 12.4 percent of the combined value of stocks held directly by U.S. individual investors and in personal trust accounts on that date (Securities and Exchange Commission, *SEC Monthly Statistical Review*, July 1979 and August 1981). More recent data are not available. The SEC no longer publishes its series on holdings—"probably largely because of growing awareness of the inadequacies of the estimates for holdings of some of the types of institutional investors included"—and data published by the New York Stock Exchange (*Fact Book*, various years) on holdings of NYSE-listed stock excludes bank administered personal trust funds as well as private hedge funds (limited partnerships that speculate in securities), and non-bank trust funds because "no method exists to estimate their holdings" (Julius W. Allen, *Institutional Investors and Their Role in Equity Financing and Corporate Governance*, Congressional Research Service, Report No. 85-163E, August 29, 1985, pp. 9-19).

As the share of corporate securities held by institutional investors grows larger, the tensions and contradictions between the historic objectives of securities law and regulation and the objectives of pension fund and trust fund managers become sharper and may have contributed to undermining the economic functions of the markets. This would be true if, for example, risk aversion had encouraged pension fund managers to devote a larger share of funds to medium-term corporate bonds.[58] The rapid turnover of pension funds' equity holdings suggests that managers have little interest in holding assets over time and, thus, may prefer shorter-term issues.[59] In that case (and given their dominant role as investors in corporate bonds), their demand for assets in this maturity range may have put downward pressure on the maturity structure of corporate bond issues just as the growth of money market funds resulted in increased demand for commercial paper and encouraged its issuance.[60]

Some pension fund plans—especially defined benefit plans—tend to encourage investment strategies that maximize the funds' performance in a short time frame.[61] High earnings in a given year allow the employer-sponsor to reduce contributions to the fund in the following year.[62] This may discourage long-term investment strategies that involve the purchase of new issues or the issues of small or new companies or emerging industries. Instead, pension fund managers may favor stocks of large established companies which can be readily bought or sold[63] and short-term money market securities. Moreover, they may focus on factors affecting the price of outstanding stocks—dividend payouts, rumors of takeovers, etc.—rather than the underlying or long-term worth of the company. Many corporate executives and analysts believe that money managers' emphasis on short-term performance has, in turn, discouraged corporate managers from focusing on long-term objectives. This may discourage funding for research, the development of new products and the commercialization of new technologies and, thus, may undermine the growth potential and future performance of established companies.[64]

---

[58] It is always difficult to assess the future prospects of a given company or industry; equally difficult to maximize returns on long-term, fixed rate assets in a period of interest rate instability. Nevertheless, the combination of these two objectives—minimizing risk and maximizing returns in a short time frame—may undermine the future prospects of companies and industries and increase interest rate instability if these are the objectives of a dominant class of investor.

[59] See the statement of Robert A.G. Monks at footnote 65 below.

[60] Pension funds hold relatively small amounts of commercial paper. The majority of open market paper is held by money market mutual funds (Salomon Brothers, Inc., *op. cit.*, Table 13.)

[61] As discussed in Part III, Chapter 3, private pension plans vary in terms of a number of factors. There are both defined benefit and defined contribution plans, single and multiple employer plans, plans offered by corporate managers and by unions and plans managed "in house" and by outside investment managers. While there are a larger number of defined contribution plans, the majority of all private pension fund assets are held by defined benefit plans managed by outside advisors.

[62] Higher earnings also permit corporations to recapture surplus funds in their pension plans. As discussed below, this source of funds has been used by many companies to repurchase their own stock. The Financial Accounting Standards Board (FASB) has adopted a new rule (Statement 87) that will facilitate the ability of corporations to reduce contributions (Leonard Sloane, "Companies Profit From Pension Rule", *The New York Times*, April 4, 1986, pp. D1, D3).

[63] Because of the size of their investment positions, pension funds very often have no option other than to move funds into issues of large, established companies. For example, Greta E. Marshall said the California Public Employees Retirement System would not even consider investing in companies that are capitalized at less than $50 million because a multibillion-dollar fund is unable to buy enough shares of companies that small to have any impact on its portfolio (Anice C. Wallace, "Jolting A $27 Billion Pension Fund", *The New York Times*, September 1, 1985).

The possibility that pension fund sponsors and managers do, in fact, focus on short-term performance objectives could explain the frequency of trading. However, this explanation is perplexing to one expert. As Robert A.G. Monks, former Administrator of the Office of Pension and Welfare Benefit Programs, U.S. Department of Labor, testified:

> Given their needs, pension plans should be the ideal long-term clients, since any given plan is structured to pay out a known amount of money to a defined group at a stated time. Thus it is astonishing to learn that the average turnover of pension portfolio holdings by money managers is approaching 70 percent annually. Institutional investors are the biggest players in financial markets; pension funds are the single biggest client of institutional investors. Thus the impact of that much stock changing hands that often is significant.[65]

The volatility of securities prices that results both from a high turnover rate and the size of institutional purchases and sales may have discouraged individual investors' participation in the market.[66] A journalist for *The New York Times* explained:

> The little guy has been frightened by the growing influence of the big institutional players—the pension funds, mutual funds and insurance companies. Their ability to buy and sell millions of dollars of stocks at a crack has led

---

[64] "Will Money Managers Wreck the Economy?", *Business Week*, August 13, 1984, pp. 86-93. James Tobin made the following observation on this issue:

> Keynes, himself an active and experienced market participant, despaired of 'investment based on genuine long-term expectation'. 'There is no clear evidence', he said, 'that the investment policy which is socially advantageous coincides with that which is most profitable'. He noted that professionals who bet on long-term fundamentals, while everyone else is engaged in short-term attempts 'to guess better than the crowd how the crowd will behave', run greater risks. Not least of these is criticism for unconventional and rash investment behavior. Keynes' views would be confirmed today if he observed how professional portfolio managers seek safety from criticism in short run performances that match their competitors and market indexes (Tobin, *op. cit.*, p. 9).

Some analysts, however, believe that this emphasis on short-term performance is futile if not self-defeating. Several academicians have argued that "because the stock market is efficient, the fees paid to managers, plus the trading costs from their activity, more than offset their ability to beat the market by buying undervalued and selling overvalued stocks" (Robert H. Jeffrey, "The Folly of Stock Market Timing", *Harvard Business Review*, v. 62, July-August 1984, p. 102. Quoted in Allen, *op. cit.*, p. 24).

[65] Statement by Robert A.G. Monks, *Shareholder Interests and Corporate Takeovers*, *op. cit.*, May 22, 1985, pp. 5-6.

[66] Although many observers believe that the increase in stock price volatility in recent years is due in large part to institutional trading practices, the major studies that have been conducted so far—the 1971 SEC *Institutional Investor Study Report*, a 1975 academic study and a 1982 Brookings Institution report—conclude that, while institutional investments cannot be ruled out as a factor and more work needs to be done, the available evidence does not support the allegation, and the later studies suggest that changes in interest rates are a more potent factor in stock price volatility (Allen, *op. cit.*, pp. 22-23). A more recent study, however, focuses on the propensity of many institutional fund managers "to engage in so-called market timing—that is, moving assets back and forth between equities and cash equivalents (*e.g.*, 90 day Treasury bills), often at what prove to be the worst possible times" (Jeffrey, *op. cit.*, p. 103; quoted in Allen, *op. cit.*, p. 24). It is difficult to believe that institutional shifts from stocks to Treasury bills (if frequent and of significant size) would not affect stock prices and, while they may be motivated by interest rate volatility, that they would not augment the volatility of interest rates. Efforts to collect data on such shifts might help to remedy inadequacies in current information and clarify the issue of institutional investments as a factor in stock price volatility.

> to wild price gyrations that can enrich or wipe out small investors in a week or two. And that has driven many away from the whole game, perhaps for good.[67]

In any event, the value of individual holdings of stocks fell by about $400 billion in the period 1978 through 1985, while the value of holdings of institutional shareholders rose by $221 billion (see Table 13a below).[68] This represents a sizable reduction in the number of decisionmakers in the market. As discussed in the previous chapter, such a trend could significantly disadvantage small or new companies and emerging industries, as fewer investors are involved in choosing winners and losers.

Pension fund structure and investment strategies also tend to undermine traditional notions of corporate democracy. For example, fund managers exercise control over shares held in pension fund accounts but it is unclear who owns the companies whose shares they hold—the ultimate beneficiaries (employees) or the sponsor (employer). Thus the applicability of shareholder rights is equally unclear. Voting rights in all companies whose stocks are held in a given fund are exercised by the fund manager as a function of "fiduciary responsibility". But "fiduciary responsibility" is no more clearly defined in this context than is ownership. However, the overall effect may be to concentrate the exercise of corporate governance in very few hands.[69] While this could have positive implications for corporate governance by assuring that some 30 or 40 analysts will have time and resources to evaluate managements' performance, it may discourage participation by individual investors who may see their own views as irrelevant in the context of institutional investors' voting power. Moreover, if the investment objectives of pension plan managers focus on short-term performance, any significant increase in their influence could undermine corporate managers' incentives to undertake long-term strategies for growth and development.

Overall, the questions raised by the growth of pension funds over the last 30 years are very serious in terms of public policy objectives and the future of the economy. The tensions and contradictions between the historic "mission" of securities markets and the objectives of the dominant investors in these markets may impede the markets' role in supplying funds for capital formation. Melding these disparate objectives into a coherent framework governing market practice may require new regulatory strategies to revitalize the economic function of capital markets.

---

[67] Michael Blumstein, "How the Institutions Rule the Market", *The New York Times*, November 25, 1984, pp. F1 and F21.

[68] The impact of this shift in ownership on the market is equally dramatic. As *The New York Times* article noted:

> Blocks of 900 shares or less—the small trade that is generally typical of the individual investor—now account for only 10.5 percent of all trading, down from 16 percent in 1982 and 42 percent in 1975. At the same time, blocks of 10,000 shares or more—the domain of the big institution and the Wall Street houses trading for themselves—account for 51 percent of Big Board volume, up from 41 percent in 1982 and 17 percent in 1975 (*Ibid.*, pp. F1 and F21).

[69] The concentration issue is discussed in Part II, Chapter 3 but as an example of the voting power of institutional investors, it should be noted that they held 47 percent of Phillips Petroleum stock in February 1984, and institutional ownership of the outstanding shares of some companies is as high as 60 to 80 percent (National Investor Relations Institute, *Investor Relations Update*, November 1985, p. 2). One analyst argues that asset concentration—e.g., the fact that "institutional investors have often held such large blocks of stock in a particular corporation that they could not sell them without adversely affecting the price of that stock"—is responsible for the growing tendency on the part of institutional investors to influence managers to take remedial actions (Allen, *op. cit.*, p. 25).

The impact of mergers, takeovers, leveraged buyouts and corporate stock repurchases

As discussed, mergers, hostile takeovers and leveraged buyouts financed by debt have left the corporate sector highly leveraged by historical standards. As Table 13 shows, annual cash offerings for new issues rose in the 1980s but the volume of net issues was depressed by retirements due to a substantial increase in the dollar volume of mergers. Despite a record volume of cash offerings in 1983 and another good year in 1985, the total value of outstanding equities dropped by $146 billion in 1984 and 1985, and it is estimated that by year-end 1986, $200 billion, or 10 percent of outstanding corporate stocks will have been retired.[70] This contraction is the result of merger activity coupled with an increase in corporations' repurchases of their own stock—over $13 billion in 1984—that, in part, reflects strategies to prevent hostile takeovers.[71]

---

[70] Salomon Brothers, *Prospects for Financial Markets in 1986*, p. 13.

"Equities have been retired on balance only twice before in the postwar period and in amounts that were insignificant in relation to the value of stocks outstanding. In 1978, $1.4 billion was retired, or 0.1 percent of the market value of outstanding equities, and in 1979, $1.9 billion was retired, only 0.2 percent of the total market value" (Salomon Brothers, Inc., Research Department, "Portfolio Managers' Weekly Research Summary", December 17, 1984, p. 2).

It should be noted, however, that this decline in the value of outstanding equities had no effect on the outstanding stock of physical capital. Moreover, new cash offerings in 1984 and 1985 ($24.8 and $45.5 billion, respectively) infused funds that contributed to capital formation but at a lower level than in 1983 when new cash offerings for equities were $57.1 billion and net issuance was positive ($25.8 billion).

[71] *Ibid.*, p. 2.

See also, testimony of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, *Takeover Financing: Impact on Targets, Bidders, Financial Institutions and the Economy*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., April 23, 1985, unpublished.

TABLE 13: Corporate Stock Issues - Common & Preferred
(In billions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985*	Amt Outstanding Dec 31, 1985*
Total Cash Offerings	14.6	17.1	22.1	25.5	30.4	57.1	25.4	45.5	
Conversions & Equity Swaps for Bonds	0.1	0.2	0.2	1.8	7.2	3.2	2.5	2.7	
Merger Exchanges	16.1	19.2	10.7	50.8	57.9	34.6	110.8	111.1	
For Debt	1.4	1.6	0.9	1.6	15.7	5.4	11.5	10.1	
For Cash	14.7	17.6	9.8	49.2	42.2	29.2	99.3	101.0	
Net Issuance	-1.4	-1.9	11.6	-23.5	-20.3	25.8	-82.8	-62.8	2,378.2

TABLE 13a: Change in Corporate Stock Ownership
(In billions of dollars)

	1978	1979	1980	1981	1982	1983	1984	1985*	Ownership: 12/31/85* Amount	Ownership: 12/31/85* As % of Total
Insurance Companies	1.9	3.8	3.8	4.9	6.1	5.2	-2.6	5.0	134.3	5.7
Pension Funds	4.5	13.4	23.0	14.5	28.7	31.8	4.4	29.8	499.2	21.0
Private Noninsured	1.9	9.3	17.7	5.4	20.1	15.3	-2.6	8.6	362.4	15.2
State & Local Gov't	2.6	4.1	5.3	9.1	8.6	16.5	7.0	21.2	136.8	5.8
Stock Mutual Funds	-1.6	-2.8	-1.8	-0.6	3.5	13.7	5.9	13.9	108.9	4.6
Other Financial	0.0	0.2	0.0	2.2	-0.9	5.8	3.4	2.1	84.3	3.5
Households: Direct Investment	-8.6	-18.2	-18.5	-50.4	-61.6	-36.1	-91.3	-114.2	1,436.1	60.4
Foreign	2.4	1.7	5.4	5.8	3.9	5.4	-2.7	0.5	115.4	4.9
TOTAL OWNERSHIP	-1.4	-1.9	11.7	-23.6	-20.2	25.8	-82.9	-62.9	2,378.2	100.0
Memo items:										
Total Institutional Ownership	4.8	14.6	24.8	21.0	37.5	56.5	11.1	50.6	826.7	34.8

* = Estimated

Source: Salomon Brothers Inc., Prospects for Financial Markets, 1984, 1985 & 1986, Table 3c (as compiled by Subcommittee Staff)

The rise in merger activity is seen by some as the result of the combination of depressed stock prices and high real interest rates—both of which encourage corporations to expand by buying rather than building.[72] In addition:

> It became increasingly obvious that the diversification strategies of the past two decades were ill suited to the current environment where better returns depended on tighter control of costs and a streamlining of assets and product lines. As rationalization strategies were implemented, the resulting repositioning of assets added to merger activity.[73]

All the various strategies that have resulted in the recent high level of stock retirements—mergers, takeovers, leveraged buyouts and corporate stock repurchases—have been facilitated by the continued availability of short-term credit at home and abroad, dramatic increases in corporate cash flow as a result of the 1981-82 tax cuts and, in addition in some cases, the recapture of surplus funds in defined benefit pension plans.[74] But whatever the causes, benefits or disadvantages that may result from increased takeover and merger activity and other stock retirement strategies, many believe that the trend toward lower capital and higher debt in the financial structure of the corporate sector is an ominous development—that, as one analyst noted, "We are, in fact, decapitalizing significant portions of our industrial sector, which is disquieting at best in a capitalistic society." [75]

There are any number of analyses extolling the economic benefits of takeover and merger activity. The view in favor of not interfering with the process is summed up in the *Economic Report of the President:*

> The available evidence is that mergers and acquisitions increase national wealth. They improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line

---

[72] Alan Greenspan argues that "the overall valuation of common stocks . . . by any historical criterion, remains exceptionally low" because:

> The basic problem is that the real discount factors applied to expected future dividends are decidedly high by historical standards, reflecting the high risk premiums built into long-term equity capital investments. The latter, in turn, reflect the fears of a potential re-ignition of inflation and the resultant economy-wide instabilities. Underlying the growing concern is the presumption that the financial structure is fragile and might require large inflation-generating bailouts. Perhaps even more deep-seated is the concern that yawning federal budget deficits will persist for the indefinite future, ultimately forcing a massive expansion of the money supply and inflation.
>
> * * * * *
>
> The high discount factors in effect penalize those firms that continue to take the longer term time perspective that their historic corporate cultures require of them. So long as stock prices remain low they will induce short-term profit preferences. In sum, capital costs are too high, stock prices too low.

(Alan Greenspan, "Takeovers Rooted in Fear", *The Wall Street Journal*, September 27, 1985, p. 28).

[73] Salomon Brothers, "Portfolio Managers' Weekly Research Summary", *op. cit.*, p. 2.

[74] *Ibid.*, p. 2.

[75] Testimony of Michael C. Connor, Senior Vice President, Keefe, Bruyette & Woods, Inc., *Takeover Financing: Impact on Targets, Bidders, Financial Institutions and the Economy*, *op. cit.*, p. 7 of written testimony.

> with prevailing market conditions. In addition, there is no evidence that mergers and acquisitions have, on any systematic basis, caused anticompetitive price increases.[76]

But this and other analyses of the benefits of mergers and takeovers tend to ignore what former Federal Reserve Vice Chairman Martin has termed "the potential for greater risk exposure of the financial system." As he explained:

> Because many mergers and leveraged buyouts have involved heavy reliance on debt and retirement of existing equity, the surviving firms are more vulnerable to downturns in earnings or sharp increases in interest rates. When this occurs, it means that the institutions providing the credit may in turn be more exposed to possible loss.[77]

Mergers, takeovers and other stock retirement strategies may also have contributed to a significant shift in the ownership of stocks. As discussed, stock holdings of individual investors fell by almost $400 billion between 1978 and 1985[78] with more than half the decline—$205.5 billion—occurring in 1984 and 1985 (see Table 13). Meanwhile, the holdings of institutional investors rose by $221 billion over the seven-year period. As the data show, the shift in holdings between individuals and institutional investors rose in years when merger exchanges for cash were largest.

These data suggest that the individual investor who sells stock in a takeover does not put his or her money back into the market. If this is so, why is it happening?[79] Are the takeover wars eroding investor confidence in the market? And if that is the case, will the shift in stock ownership exacerbate or slow the rise in the dollar volume of merger activity?

---

[76] *Economic Report of the President*, transmitted to the Congress, February 1985, p. 196.

A similar statement was made before the Subcommittee in March 1985 by Joseph R. Wright, Jr., Deputy Director, Office of Management and Budget:

> Takeovers can perform several valuable functions. In particular, takeovers can allocate resources to higher valued uses, promote economies of scale and scope, increase the return from investing in the stock of publicly traded companies, reinforce market incentives that require management to compete effectively, free up capital for new investment opportunities, and move assets to smaller, more focused companies.

(Statement of Joseph R. Wright, *The Impact of Corporate Takeovers on the Economy*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., March 12, 1985, p. 12-13 of transcript.

[77] Testimony of Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System, *Takeover Financing: Impact on Targets, Bidders, Financial Institutions and the Economy*, op. cit., p. 5 of written testimony.

Vice Chairman Martin added that: "With respect to credit flows, our estimates indicate that growth in the domestic nonfinancial debt aggregate . . . was boosted by about 1 to 1½ percentage points in 1984 as a result of merger-related activity" (*Ibid.*, p. 5).

[78] This decline was offset to some degree by increased investment in stock mutual funds of $40.2 billion over the same period. In 1985, net sales of mutual funds soared but government income funds and tax-exempt bond funds accounted for the biggest share of new investments. Net sales of equity (stock) funds were $7.8 billion in 1985—a miniscule amount compared with the $114.2 billion decline in direct holdings of stock by individuals—and net sales of corporate bond funds were $5.7 billion (Vartanig G. Vartan, "Mutual Funds Historic Boom", *The New York Times*, December 17, 1985, p. D 1).

[79] Some analysts argue that "individuals have reduced their direct holdings of long-term assets as pension and life insurance reserves have grown in importance" (Alicia H. Munnell, *The Economics of Private Pensions*, Brookings Institution, 1982, pp. 128-129, quoted in Allen, *op. cit.*, p. 23). This would explain the overall decline in individual holdings over time, but not the scale of the decline associated with periods of merger activity.

Some corporate executives have said that they could ignore the pressure from money managers to adopt short-term performance objectives but for the threat of hostile takeovers. They note that individual investors might forego the premium offered by a bidder because they "like the stock" or believe in the long-term prospects of the company. But institutional investors almost always go for the premium.[80] Indeed, many pension fund managers apparently believe that their primary obligation is to seek the highest possible returns for beneficiaries and that, therefore, not selling a company's stock may be inconsistent with their fiduciary duty when a premium price is offered by a raider or hostile corporate bidder.[81]

But in the long-term and in the aggregate, selling stock to the highest bidder may not minimize risk. It may contribute to an erosion in the overall quality of the bond market that will hurt all investors. Because hostile takeovers are usually financed by borrowing from banks or new debt issues, the quality of an acquiring company's outstanding debt may deteriorate. And since the corporate bond market is thinner and less liquid than the equity market—largely because institutional investors hold about 80 percent of total outstanding issues and pension funds about 30 percent—the additional leveraging of corporations that results from merger, takeover and leveraged buyout activity financed by debt may result in a decline in the marketability of outstanding debt issues held by pension funds.

Given the rise in debt relative to capital, the overall effect of responding only to the short-term gains that accrue to institutional investors that sell stocks at the premium offered by bidders may be a significant increase in overall risk. As SEC Chairman John S.R. Shad observed:

> Major bankruptcies have resulted from the heavy debt incurred by companies that have engaged in aggressive acquisition programs (e.g., Baldwin-United, Charter Corp., Lionel, Saxon Industries, Wickes and many others).
>
> When a company highly leverages its capitalization, the consequences of even modest business problems, economic

---

[80] These remarks were made in informal discussions with Members and staff of the Subcommittee on Telecommunications, Consumer Protection and Finance.

Others would argue that rational stockholders, institutional or individual, accept premia. However, individuals need information and time to digest it—an underlying concern expressed in the Williams Act and in more recent proposals to extend minimum offering periods and discourage two-tier tender offers.

[81] "Will Money Managers Wreck the Economy?", *Business Week*, August 13, 1984, p. 89.

In recent testimony before the Subcommittee on Telecommunications, Consumer Protection and Finance, former Labor Department Administrator of ERISA, Robert Monks, sought to "clarify a misconception" about the fiduciary responsibilities of pension fund managers in takeover situations. He said:

> There is no obligation for a fiduciary to sell his stock to the highest bidder, even if the price bid has never before been offered. Peter Drucker is among the scholars who have concluded that fiduciary ownership is the equivalent of a "For Sale" sign. Last November, I wrote a letter to the Wall Street Journal responding to an article by Professor Drucker, in which I noted that, 'ERISA's requirement is that a pension fund fiduciary, in evaluating such a bid, must act prudently and solely in the interests of plan participants and beneficiaries. What this requires is a solid, careful evaluation of long-term prospects of the company under existing management as against the short-term prospects presented by the takeover offer and by the ability to invest the proceeds of the takeover offer in another enterprise. The results of such an evaluation may well vary from case to case.'" (Statement of Robert A.G. Monks, *Shareholder Interests and Corporate Takeovers*, *op. cit.*, p. 6 of written testimony.

> recessions or rising interest rates, are greatly magnified. Shareholders, creditors and others have sustained billion dollar losses—in addition to the serious impact of bankruptcies on employees, communities, suppliers, customers and others.
>
> The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition related bankruptcies. The premiums come first, the consequences later. The leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates.[82]

In summary, not only do hostile takeovers financed by debt fail *per se* to increase capital formation, they may also have an indirect negative influence on long-term corporate performance. The apparent association between mergers and the shift in stock ownership from individuals to institutional investors is important because it reduces the number of decision-makers in the market. As discussed in the previous chapter, shrinking the number of decision-makers not only undermines the efficiency and liquidity of the markets, it undermines the market system itself. The economic function of the capital markets in financing future growth of both established companies and new or small companies and emerging industries could be seriously impaired if the apparent linkages between shifts in shareholder ownership, merger activity and the decapitalization of the corporate sector persist. At risk are both the financial viability of issuers and investors and the competitiveness of the U.S. economy.

---

[82] John S.R. Shad, Chairman, Securities and Exchange Commission, *The Leveraging of America*, speech before the New York Financial Writers Association, June 7, 1984, p. 4 (copy on file with the Subcommittee).

Innovative and derivative securities products

The proliferation of innovative and derivative financial instruments—options,[83] futures,[84] options on futures,[85] stock index options and stock index futures,[86]—is seen as "partly the result of the natural evolution experienced by any industry over time and partly a strategy for survival." [87] The perception that they play a role in a strategy for survival is based on the belief that market uncertainty and volatility have required new methods of shifting risk.[88] For example, investors can protect themselves against a

---

[83] An option gives the purchaser the right to buy (a call option) or sell (a put option) a specific security or commodity at a specified date (European option) or over a specified period of time (American option) in exchange for a present payment or premium. Because option traders may decline to purchase or sell the underlying asset, their losses are limited to the premium. But the potential for gains is great. However, for the trader to realize a profit, gains in the underlying asset must be enough to cover transactions costs and the cost of the premium paid for the option. An option only has value for a specified period of time. At expiration, the option is worthless. It is therefore known as a "wasting asset." (For further discussion of options see: *A Study of the Effects on the Economy of Trading in Futures Options*. A Report by the Board of Governors of the Federal Reserve System. The Commodity Futures Trading Commission and the Securities and Exchange Commission, to the Committee on Agriculture and the Committee on Energy and Commerce of the House of Representatives, and to the Committee on Agriculture, Nutrition and Forestry and the Committee on Banking of the Senate. December 1984, pp. II-1-II-3.)

[84] A futures contract is an agreement to buy or sell a specific commodity or security at a specified place and time in the future for a specified price. While an *option* is the right, but not the obligation, to purchase or sell an asset, a *future* carries the obligation to deliver or accept delivery of the specified asset. Generally, however, futures contracts are settled without delivery.

There are five elements common to all futures contracts: (1) the quantity of the assets to be delivered; (2) the quality of the assets to be delivered; (3) the time at which delivery is to be made; (4) the location of delivery; and (5) the identity of the counterpart to every purchase and sale. (*See*, *Issues in the Regulation of Futures and Options Trading*. By Julius W. Allen, Congressional Research Service, June 3, 1983, pp. 6, citing Hendrik S. Houthakker, "The Extension of Futures Trading to the Financial Sector," *Journal of Banking and Finance*, v. 6, March 1982, p. 27.)

[85] An option on a future is the right, but not the obligation, to buy or sell a futures contract. Unlike regular options which are the right to buy or sell an asset, an option on a futures contract carries no rights to the underlying assets. However, the principle is the same as in the case of an options contract.

[86] Stock indexes are the measure of price movements in a group of stocks. They can be based on a specific industry, such as the American Stock Exchange Index on Computer Technology, or designed to reflect the market as a whole, such as the Standard and Poor's "500" index.

Stock index options are similar to regular options except that settlement of the option contract is always done in cash, since a stock index is not a deliverable instrument. The settlement price is computed by the difference between the option exercise price and the closing level of the underlying index on the date of settlement.

A stock index future is a standardized contract on a stock price average—or index—which is settled at some time in the future. (New York Futures Exchange, Inc., "Stock Index Futures and the Prudent Man," *Institutional Investor*, Oct. 1985, p. 41.) Stock index futures are settled in the same manner as stock index options, with the difference computed between the value of the underlying index and the value of the contract. There are also options on stock index futures which are options to buy or sell the specified stock index future within a specified time period for a specified price. (*Ibid.*, p. 42.)

Stock index options and stock index futures are viewed as a means for temporarily investing in the market (as a whole) while deciding which specific stocks to buy. (Arlene Hershman, "Stock Indexes: Fast and Flexible," *Duns Business Month*, September 1984, p. 61.)

[87] James Balog, "New-Product Fever Will Subside Once Rates, Inflation Calm Down," *Financier*, Vol. VII, No. 8, August 1983, p. 56.

[88] For example, a farmer may shift his risks on his corn crop by hedging. He can protect himself in the spring by selling in the futures market an amount of corn equal to what he will harvest in the fall. The farmer has taken a short position in the market; he has contracted to deliver corn at a future date for a price set now. The farmer has "locked in" a price and consequently protects himself against a drop in the price of corn but also foregoes the possibility of a rise in the price.

While a future hedger removes all risk from the transaction by "locking in" the future price of the asset, he can also make a profit by taking advantage of the spread between the cash price and the futures price (known as the basis). In the case of a commodity or stock, the variable is the price of the underlying asset; in the case of a financial future, the variable is the interest rate. (*Issues in the Regulation of Futures and Options Trading*, Julius W. Allen, p. 11.) The cost to a futures hedger is the premium paid for the contract. However, this premium is based on the

Continued

change in the price of a given stock by writing options (or "puts" and "calls") to buy or sell the stock at a certain price at a certain time, and therefore limit their risk on investments in shares of companies. These investment vehicles are different from futures contracts that are traded in commodities markets, that entail an obligation to buy or sell and place on the investor the gains or losses on a given amount of an underlying commodity.[89]

Listed stock options were introduced on the Chicago Board Options Exchange in 1973. By 1982, the annual volume had risen to 137.3 million contracts, representing 13.7 billion shares of stock, and was equivalent to 83.4 percent of the shares traded on the New York Stock Exchange.[90] The aggregate volume of stock index options, foreign currency, and debt options for the first quarter of 1984 alone was 50.23 million contracts. The same period of 1985 saw the trading of 58.86 million contracts, even after 4 options products had been delisted from the CBOE. Assuming the first quarter of 1985 is representative of the remainder of the year, one could project an annual volume of 235.43 million contracts on stock options for 1985.[91]

Buying stocks moves the investor one step away from the underlying asset which is the physical assets and entrepreneurial activity of the company itself. Buying stock options represents a two-step move away from the underlying asset. But other, even newer instruments—stock index futures and options on commodity futures—puts the investor at an even greater distance from entrepreneurship and the primary and secondary markets for stocks, bonds and commodities. Trading in stock index futures began in the spring of 1982 and on 28 days that year, the dollar volume in index futures traded exceeded that of the New York Stock Exchange.[92]

---

futures price which is based on the uncertain expectations about what the actual price of the underlying asset (or stock index or option) will be on the date the contract expires.

The investor uses similar strategies to protect his financial holdings. For example, he may purchase an option to sell a stock at a specified price over a specified time to prevent a loss if the price of the stock declines.

As witnesses before the Subcommittee observed:

> I think the reason that these instruments are attractive is because they enable both financial intermediaries and also end users to protect themselves against risk" (Testimony of David O. Beim, Executive Vice President, Corporate Finance Department, Bankers Trust Company, *The Expanding Securities Markets: Regulatory and Economic Issues, op. cit.*, May 2, 1985, p. 331.
>
> I think you can put it even more simply by saying anyone who has a portfolio of treasury certificates, or any institution that has a portfolio of treasury securities, by simply holding it is undergoing very substantial risk, so you don't reduce the risk by barring the use of derivative instruments. The interest rates have become so volatile that anyone holding fixed income securities is subject to very substantial risk. It has nothing to do with credit. It has to do with market risk. You can't make it go away. All you can do is try to manage it. (Testimony of Stephen J. Friedman, Debevoise and Plimpton, *Ibid.*, p. 340).

[89] The difference between options and financial or commodities futures is underscored in the following observation:

> Clearly an option is a much more attractive product, because as a bare instrument, that is without combining it with other offsetting strategies, your loss is limited to the premium for the option, and there is no liability. Having a futures contract alone is analogous to a short sale in which you have got a continuing exposure. (Testimony of Stephen J. Friedman, *Ibid.*, p. 331.

[90] Balog, *op. cit.*, pp. 56-57.

[91] Information based on a table of aggregate trading volume composed by Division of Market Regulation, Securities and Exchange Commission.

[92] Balog, *op. cit.*, p. 57.

By mid-1983, the volume of contracts traded exceeded 48,000 a day with a face value of about $3.2 billion or the equivalent of an 85-million share day on the New York Stock Exchange.

These new products—together with U.S. government note and bond futures and currency futures and options—have greatly expanded the markets and the overall volume of trading in derivative instruments. In 1984, the average daily volume of transactions in futures on government securities totaled $26 billion or 50 percent of cash transactions, up from $8 billion or 40 percent in 1983. And trading in currency options—introduced in 1982—totaled $33.3 billion in 1984, an eightfold increase over 1983.[93]

While the proliferation of derivative instruments and their enthusiastic acceptance by investors have provided a new source of growth and profits for securities and commodities firms, they are not without certain negative aspects. In 1983, the Securities Industry Association's Committee on Derivative Products asked for a moratorium on product proliferation on the grounds that the glut of new products was "fragmenting the markets, straining operational capabilities and confusing the public." [94] James Tobin has raised other, related concerns:

> The new options and futures contracts do not stretch very far into the future. They serve mainly to allow greater leverage to short-term speculators and arbitrageurs, and to limit losses in one direction or the other. Collectively they contain considerable redundancy. Every financial market absorbs private resources to operate and government resources to police. The country cannot afford all the markets that enthusiasts dream up. In deciding whether to approve proposed contracts for trading, the authorities should consider whether they really fill gaps in the menu . . . not just opportunities for speculation and financial arbitrage.[95]

And some question their value in reducing risk:

> While their purpose presumably is to reduce risk, not all transactions are perfect hedges, and not all arbitrages work as anticipated. This type of activity tends to enlarge

---

[93] Kaufman, *op., cit.*, p. 8.

[94] Balog, *op. cit.*, p. 58.

In response to this request, the SEC required a brief phase-in period for introducing new stock index options.

The issue of market fragmentation was also raised by the American Stock Exchange in a paper noting that derivative instruments and other developments that have either been stimulated or facilitated by technological advances "have introduced new challenges for the regulator, particularly with respect to market surveillance and enforcement." (Richard O. Scribner, Executive Vice President, American Stock Exchange, "The Technological Revolution in Securities Trading: Can Regulation Keep Up?", *Technology and the Regulation of Financial Markets*, Edited by Lloyd White and Anthony Saunders, Lexington Books, D.C. Heath & Co., 1986, pp. 1-2 of unpublished manuscript on file with the Subcommittee). But the New York Stock Exchange has taken a more laudatory view:

> There is no evidence that derivative products have harmed the marketplace. On the contrary, we believe these products can bring substantial benefits to the country's equity markets. For this reason the Exchange has committed its resources to these new products and to their orderly growth. We believe our presence will help to direct this growth in a fashion which protects investors and the public interest, and supports the economic health of the nation.

(Submitted statement of Ivers W. Riley, Executive Vice President for Diversified Products, New York Stock Exchange, Inc., *The Expanding Securities Markets: The Economic and Regulatory Issues*, *op. cit.*, p. 373.)

[95] Tobin, *op. cit.*, pp. 13-14.

> asset and liability positions and thus increases the need for improved risk control management.[96]

Meanwhile, some observers have raised questions about their economic value:

> The more "derivative" an investment vehicle, the further away it takes us from the basic purpose of financial markets—capital formation.
>
> The more tangential an investment instrument is to capital formation—the weaker the instrument's economic justification and the closer to speculation it becomes.
>
> * * * * *
>
> That weakens the financial system and starves the industrial sectors.
>
> The center of our financial system—the primary and secondary markets—provide the greatest support for economic activity and job creation.[97]

---

[96] Kaufman, *op. cit.*, p. 8.

Other commentators take a more qualified view of the potential for risk:

> There are a few limited examples of where arbitrage in the settlement of contracts, options at the day of settlement, has caused some disruption, but you are talking about fractional types, very incidental. On the other side of it, I think the benefits outweigh the detriments of the options and futures markets, significantly outweigh them. (Testimony of SEC Chairman John S.R. Shad, *The Expanding Securities Markets: The Economic and Regulatory Issues*, *op. cit.*, p. 270.)
>
> * * * * *
>
> Properly utilized, and they are not always properly utilized, these various devices for permitting hedging permit a better match between assets that are coming in down the road and liabilities that may and in most cases do have a different maturity . . . mature down the road at other points in time. (Testimony of Federal Reserve Board Vice Chairman Preston Martin, *Ibid.*, p. 40.)

[97] Balog, *op. cit.*, p. 58.

This view, too, is subject to qualification:

> With reference to derivative financial instruments, the Congressionally directed operations futures study by the Federal Reserve Board, the CFTC and the SEC delivered to Congress on December 31, 1984, found that these instruments have not had a negative effect on capital formation and appear to have enhanced the liquidity of some of the underlying cash markets. These new instruments permit corporations and investors to hedge stock market, foreign country and other risks, at much lower cost than prior means of hedging or reducing such risks. (Testimony of SEC Chairman John S.R. Shad, *Ibid.*, p. 11.)

Chairman Shad's characterization of the conclusions of this Congressionally mandated study is not quite accurate. What the study actually concluded was that:

> Since the new financially based futures and options markets have been functioning for only a short time and are, indeed, in a formative stage of development, it is not yet possible to conduct statistical tests that have convincing discriminatory powers. Against this background, at the present time, these markets can be found to have no discernible influence on capital formation in either a positive or negative way (*A Study of the Effects on The Economy of Trading in Futures and Options*, *op. cit.*, p. I-17).

Other views on this issue include the following:

> Those instruments are playing a valuable role not related to capital formation but related to asset management. (Testimony of David O. Beim, Executive Vice President, Corporate Finance Department, Bankers Trust Company, *The Expanding Securities Markets: The Economic and Regulatory Issues*, *op. cit.*, p. 341.)
>
> * * * * *
>
> In thinking about the usefulness of derivative instruments, you have to ask yourself—and I am not clear personally as to the answer—is it serving a similar function to the secondary markets? Is it also useful in supporting the capital-raising process? And I think that the testimony from people who are engaged in the capital-raising process, the investment bankers and the bankers who go out and raise money for American corporations, is that it is very helpful. And so, in a way, talking about a diversion of capital to me somehow misses the point of what all the secondary market activity is about. (Testimony of Stephen J. Friedman, Debevoise and Plimpton, *Ibid.*, p. 341.)

And there are other, more specific concerns about how the proliferation of derivative instruments based on Government issues affects the traditional economic function of capital markets:

> The highly developed futures market in Governments gives this segment an enormous advantage over both the corporate and municipal sectors. The Government futures market facilitates the distribution of new Government issues and broadens the depth of the secondary market. If, by chance, credit quality deteriorates in the private sector, this comparative advantage of Governments would become even more pronounced.[98]

Many would argue that, without these new instruments, "new capital might have been even harder to come by"; that the introduction and proliferation of derivative instruments "are not the cause, but rather, the result of instability in the financial marketplace," and that, if stability returns, "the feverish pitch of proliferation of financial instruments will abate." [99] Others would argue that the extent to which derivative instruments may contribute to instability is now a matter of greater concern[100]—that, at this remove from their introduction, the chicken or egg paradox of creation has become more applicable in sorting out the issue. And if they do contribute to destabilizing the markets, will that encourage financial entrepreneurs to create yet a new generation of derivative products, even further removed from underlying assets, that will undercut further the economic purpose of the market?

Meanwhile, if derivative financial products are moving markets away from their economic purpose—capital formation—should that trend be viewed with benign neglect? Should we be concerned if trading volume in derivative instruments exceeds the volume of trading in the secondary markets? Does it mean that excessive speculative activity is undermining the economic function of the markets?[101] If so, the risk to financial institutions and to the econ-

---

[98] Kaufman, *op. cit.*, p. 8.

[99] Balog, *op. cit.*, p. 58.

[100] For example, it is now widely believed that "basis" or "relationship" trading—a form of arbitrage that takes advantage of price disparities between a stock market index and a futures or options contract on that index—"destabilizes the market by creating and accentuating wide swings in trading" ("Let 'Basis' Trading Die a Natural Death", *Business Week*, September 30, 1985, p. 132). In the summer of 1985, trading volume became "enormous" and the stock market made 10 "distinct, important moves" without any rational explanation other than basis trading. ("A New Breed of Investor Is Whipsawing Wall Street", *Business Week*, September 23, 1985, p. 84).

As *Business Week* explains: "The impact of basis trading on the stock market has been most pronounced in the final hour of trading when the futures and options contracts expire on the same day. This happens four times a year. That 60-minute period has become known as the 'triple witching hour' because basis traders are frantically buying or selling stocks in the final hour to offset expiring futures or options" (*Ibid.*, p. 84). While defenders of basis trading argue that the short-term price swings in the underlying stocks resulting from these trades have no long-lasting effects, others argue that the increase in volatility may frighten individual stockholders and increase their losses for reasons that have nothing to do with valuation of stocks (*Ibid.*, p. 85). In response to these concerns, the SEC is asking several exchanges to limit the number of stock-index options contracts that traders can hold on expiration days to curb "last minute" trades and dilute the stock market swings with which they are associated (Pamela Sebastian, "SEC May Reduce Expiration Day Limits on Stock Index Options To Dilute Swings", *The Wall Street Journal*, September 26, 1985, p. 8).

[101] "Excessive" speculative activity is very difficult to quantify. Moreover, as Roberto Mendoza, Executive Vice President, Morgan Guaranty Trust Company, noted:

Continued

omy could be greater than the benefits that derivative products presumably provide.

Mortgage-backed securities and the emerging market for securitized debt [102]

There has been a dramatic change in the way housing is financed in U.S. financial markets in the wake of strong inflationary and interest rate pressures, the recent crisis in the thrift industry, and the phasing out of Regulation Q interest ceilings on small, short-term deposits. Traditional mortgage lenders, thrifts and banks, are less willing or able to hold long-term, fixed rate mortgages in their portfolios. While these institutions continue to orginate and service mortgages, a large portion of the mortgages they originate (as well as those of non-depository lenders such as mortgage bankers) are sold to federally-sponsored agencies—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—where they are pooled and used as backing for securities issued by these agencies and sold in the capital markets. In addition, the Government National Mortgage Association (Ginnie Mae) guarantees securities issued by depository institutions and mortgage bankers that are backed by pools of mortgages.

In 1983, $89 billion of mortgage backed securities were sold—up from $54 billion in 1982 and an average of $20 billion a year between 1977 and 1982. About $72 billion of the $190 billion of new one-family to four-family mortgages created in 1983 were financed through the sale of mortgage-backed securities (MBS), and other securities sold were backed by existing mortgages purchased from portfolio lenders. Almost all of these securities were issued or guaranteed by government-related agencies. Only $2 billion were sold by private issuers. At year-end 1983, outstanding mortgage-backed securities issued or guaranteed by government-related agencies totaled $243 billion or 20 percent of all outstanding mortgages, and rose to $368 billion or 23 percent of the total at year-end 1985. Outstanding private issues were $10 billion in 1983 but new issues rose to $18.6 billion in 1985 and accounted for 19 percent of total new issues of financial and non-financial corporate debt.[103] Total trading in mortgage-related assets reached $1.6 trillion in 1984, more than the dollar value of trading in the world stock exchanges.[104]

In 1984, changes in the securities laws were enacted to encourage private issues of mortgage-backed securities.[105] While intended to

---

Markets require speculators on one side of the transaction, a part of them. That is what makes markets efficient. And we would take the position that there clearly is speculative activity, but that the speculative activity contributes to the overall efficiency of the markets, both in terms of liquidity, lowering of costs, and the ability of financial intermediaries to hedge their positions. (*The Expanding Securities Markets: The Economic and Regulatory Issues, op. cit.*, p. 332.)

[102] Securitized debt differs from debt securities in that debt securities are issued directly by a single borrower and, in the case of corporate bonds, backed by tangible assets, while securitized debt is issued by financial intermediaries and backed by pools of loans to multiple borrowers.

[103] Merrill Lynch Capital Markets, *Corporate Finance Review 1985*, January 1986, p. 2.

[104] David O. Maxwell, *Financial Restructuring, op. cit.*, p. 246.

[105] For a description of these changes and a discussion of the development of the market and Congressional policy with respect to mortgage-backed securities, see *Secondary Mortgage Market Enhancement Act of 1983*, Rept. 98-994 Part 1, U.S. House of Representatives, 98th Cong., 2nd Sess., September 6, 1984.

facilitate the flow of funds to housing and alleviate the burden on the government-related agencies, the report on the legislation submitted by the House Energy and Commerce Committee recognized "that this expansion in the mortgage-related securities market has broad economic implications." [106] Noting a speech by Henry Kaufman, Vice Chairman of Phibro-Salomon, Inc., to the Conference Board in February 1984, the report warned that the expanding market for mortgage-backed securities could "crowd out" corporate borrowers; that the long-term capital markets are and will be dominated by mortgage-backed securities (which exceeded the gross issuance of corporate bonds by 60 percent in 1983) and government borrowing, and that continued growth could have an adverse impact on financing options for corporate borrowers.[107] In view of these concerns, the Committee requested the Federal Reserve Board and the Securities and Exchange Commission "to monitor the competitive effect of mortgage-related securities on the availability of long-term financing for corporations", and report back to Congress on these issues two years after the date of enactment.[108]

As discussed, the growth of the secondary mortgage market illustrates how changes in financial structure and regulation alter the allocation of credit. Although the Committee recognized "that by encouraging the private sector to enter the mortgage-related securities market, it is encouraging the flow of funds to housing and thereby implicitly allocating capital,"[109] the growth in the market before Congress modified securities laws and regulations to meet the needs of private issuers reflects enhanced use of existing, alternative allocative strategies. The role of government-related agencies and mortgage pools in stabilizing mortgage markets by helping thrifts adapt to interest rate deregulation enlarged their participation in the market. This resulted in a shift in mortgage financing from depository institutions to the capital markets.

The capital markets will continue to be a major source of financing for housing. Despite a dramatic rise in adjustable rate mortgages (ARMs) created by thrifts in 1984 and retained in their own portfolios,[110] a larger share of mortgage credit is created by nondepository lenders (mortgage bankers) than in the past. Mortgage bankers—many of which are owned by banking, securities and commercial conglomerates—must borrow the funds to finance their lending operations and thus prefer to act as middlemen between borrowers and investors rather than hold mortgages. Access to public securities markets facilitates an expansion of the volume of lending by these intermediaries, (some of which use affiliates to underwrite their issues) and of their role in housing finance.

The change in the structure of mortgage finance has undercut the traditional mission of thrifts. Much of the focus of financial restructuring to date has been on adjusting the asset powers of thrifts to retain their viability as intermediaries. There has been very little discussion of the impact of this structural change on the capital markets.[111] Not only has the traditional mission of these markets in funding capital formation been altered, it has been undercut by allocative mechanisms that favor the housing sector at the expense of the corporate sector.

---

[106] *Ibid.*, p. 15.

[107] *Ibid.*, p. 15.

[108] *Ibid.*, p. 16. The bill became law on October 5, 1984.

[109] *Ibid, p. 15.*

[110] ARMs may not remain indefinitely in thrift portfolios. Efforts are already being made to solve the problems involved with securities issues backed by ARMs. The ability of Fannie Mae or Ginnie Mae to issue or guarantee securities backed by ARMs could greatly increase the flexibility and lending opportunities of nondepository lenders. And it may encourage thrifts to sell ARMs to increase their volume of originations.

Even so the proliferation of mortgage-backed securities may be only a first step in the restructuring of capital markets brought about by a wider trend toward securitizing debt. One recent development involves the issuance of securities backed by automobile loans—CARs (collateralized automobile receivables), as they are called. Proposals to devise rating procedures for securities backed by business plant and equipment loans are also being considered[112] in response to a trend toward loan sales by commercial banks.[113] These hybrid business bonds further disadvantage small companies or companies with low credit ratings because their loans are more difficult to sell to investors.[114] On the other hand, these and other forms of securitized credit are said by some to be a boon to investors. As SEC Chairman John S.R. Shad observed:

> Securitization permits institutions and individual investors to obtain returns close to those previously only available to prime lenders, as well as diversification, professional selection, liquidity; and, in some cases the benefit of Government guarantees or private insurance.[115]

The benefits of securitization for financial intermediaries were summed up by David C. Batten, Managing Director, The First Boston Corporation:

> Basically, what the securitization process does is allow companies to take assets on the balance sheet, liquify them and sell them to willing investors, for whom they make sense as assets. The process is important in that it allows a much better matching of assets and liabilities, avoiding interest rate maturity risk. It provides new sources of funds for those companies that choose to liquify their balance sheet, and probably equally importantly, maybe more importantly in an environment when both regulating agencies and regulators are worried about capital, because it allows sale of assets; it, in effect, frees up equity capital that would otherwise be required to support those assets on the balance sheet.[116]

---

[111] These issues were not discussed by the Senate in Committee or floor debate on either the Secondary Mortgage Market Enhancement Act (S. 2040) or the Garn bill (S. 2181). S. 2040 was not even considered by the Senate subcommittee with securities jurisdiction.

[112] "Commercial Mortgages: A New Rating Approach," *Credit Week*, Standard and Poor, November 19, 1984, p. 1.

[113] One major bank—Bankers Trust Company—has developed a strategy that calls for converting "all the bank's corporate loans into the equivalent of interest-bearing bonds that can be sold to investors". (Robert A. Bennett, "Sanford's New Banking Vision", *The New York Times*, March 17, 1985, p. F 1).

[114] *Ibid.*, p. F 28.

A price/yield adjustment that makes the loans salable may raise their cost to borrowers relative to the cost of bank credit.

[115] *The Expanding Securities Markets: The Economic and Regulatory Issues*, *op. cit.*, p. 204.

[116] *Ibid.*, p. 293.

Such innovations will tend to enhance the role of finance companies in credit creation at the expense of commercial banks. While large banks that already own consumer and business finance companies may not be disadvantaged in competing with companies owned by other financial and commercial conglomerates (except in terms of the existing limitations on their ability to underwrite securities issued by their finance affiliates), small banks may be significantly disadvantaged. And the traditional mission of all banks will be undermined. Banks will continue to originate consumer and commercial loans but they, like thrifts, may find it more convenient to sell loans given their greater dependence on interest-sensitive, short-term deposits, and because they will not have to raise capital to back a larger volume of loan originations.

As a wider number of debt obligations are securitized and finance companies assume a larger share of loan originations, the importance of banks in the financial system will diminish. As has already been demonstrated in the case of mortgage-backed securities, the maturity of securitized debt can be adjusted to meet different maturity preferences in order to attract a wider group of investors, including depository institutions. Short-term securities are likely to become an even more attractive substitute for time deposits. And the capital markets may become an even more important segment of the financial system—populated by a wider group of intermediaries, issuers and investors—but further removed from its traditional function of providing long-term funds for capital formation, particularly if securitizing debt increases utilization of the markets for short-term investment.

A continuation of the trend toward securitizing debt will have a significant negative impact on the implementation of monetary policy under current procedures. As discussed, the banking system is the conduit for policy initiatives that rely on purchases and sales of government securities to alter the cost and availability of bank reserves, and on discounts and loans to banks against eligible collateral.[117] If banks become less important as direct lenders, monetary policy leverage will be weakened. Moreover, changes in the composition of bank assets necessarily affect the Fed's ability to use the discount window as a policy tool in the normal course of events, and to exercise its role as lender-of-last resort.

The implications of securitizing debt for the conduct of monetary policy are important not only in terms of the macroeconomic environment but in terms of market stability. Some analysts believe that securitized debt adds to risk. An analysis of both the benefits and risks of securitization was offered by former Federal Reserve Board Vice Chairman Preston Martin:

> The ability to sell loans has clear benefits for banks. It makes the asset side of their balance sheets more liquid; it allows banks to manage their assets. They can spread individual-borrower risks better and control the proportions of different borrower and maturity categories. The securitizing of loans broadens the range of investment opportuni-

---

[117] The term "banks" is used in a generic sense to include thrifts whose asset and liability powers have been significantly liberalized to approximate more closely those of banks.

> ties for many investors, offering yet another alternative for increasing the liquidity of a portfolio and diversifying risk. This helps some borrowers compete on more even terms for funds. The extent to which additional funds acquired by households to purchase houses or autos crowd out business borrowing is still a matter for continued research.
>
> There are, however, some increased risks accompanying the packaging and sale of loans. In some private loan packages, the origination is separated from the actual lending of funds, with third parties insuring the loans, still others doing the loan packaging, and even different firms holding the loans in escrow or as trustee. This, as the recent experience of California banks suggests, may tend to encourage sloppy procedures and inadequate loan evaluation as each party relies on others to investigate the loans thoroughly. Furthermore, ultimate purchasers of the securities, who sometimes bear the most risk, may lack the expertise and information to make proper investigations.[118]

And in discussing what he perceives as the drift "toward a financial system in which credit has no guardian", Dr. Henry Kaufman observed that:

> Increasing securitization of credit obligations is another development that has contributed to the shift to unencumbered credit. This need not be the case when a nonmarketable obligation is transferred into marketable form. The potential of significant abuses is raised by the hidden rationale behind securitization, the misconceptions about marketability, and the transfer into marketable form of poor-quality assets.
>
> Today, many institutions do not want to be bound to borrowers. They prefer the opportunity to disengage through securitization. This opportunity, however, loosens the link between creditor and borrower. In a nonmarketable relationship, the creditor is tied to the borrower for the life of the loan. By definition, the credit scrutiny at the inception of the loan or investment is usually quite intensive. In a securitized arrangement, many market participants today fail to distinguish between the essence of liquidity and marketability. Liquidity means, of course, being able to dispose of a financial asset at par, while marketability provides the holder the opportunity to sell at some price. The illusion of marketability is that the holders of obligations will be able to sell their investments before a significant deterioration in credit quality is generally perceived. Thus, the initial pressure to be highly circumspect in the creation of the obligation does not exist. Many of the new marketable obligations, moreover, have yet to be tested by adverse business conditions. In addition, the fact remains that the financial system, as a whole, and therefore many

---

[118] *The Expanding Securities Markets: The Economic and Regulatory Issues, op. cit.*, pp. 238-239.

> of the participants, cannot divest from their portfolios credit obligations that are unwanted by the market.[119]

In his January 1985 address to the National Press Club Dr. Kaufman also noted that:

> The increased securitizing of debt will raise the question of whether banks which had historically been the lender to low-credit-quality borrowers, will step in as lenders if open market financing were to dry up, given deteriorating credit worthiness or if general credit stringency developed.[120]

As these observations suggest, existing threats to market stability could be intensified if the traditional procedures for stabilizing markets are impaired—if banks fail to perform their historic function as a back-up source of liquidity and as conduits for liquidity created by the monetary authority. The pervasive tendency to confuse marketability and liquidity has obscured the critical role that the government's monetary powers and responsibilities plays as an ultimate source of liquidity. It has also obscured the fact that exercising that role depends on the interactions between the monetary authority and the financial system, and that success or failure depends, in turn, on the institutional context in which these interactions take place.

In summary, it could be argued that the rise in securitized debt is merely the outgrowth of other changes in financial structure and regulation. Even so, it constitutes the most profound of the many structural changes that are occurring in financial markets. It has significantly altered credit flows and is altering almost all relationships between institutions, borrowers and investors. As a result, its economic impact is likely to be equally pervasive and profound. The most obvious (and already visible) consequence is that the once-central function of capital markets in financing capital formation is becoming a peripheral activity.

SUMMARY OF POLICY CONCERNS

The weaknesses in corporate investment and in productivity growth rates are seen by many as critical problems for the U.S. economy. Some believe these problems can best be solved by using a variety of interventionist strategies that fall under the general classification of industrial policy. Others believe that the solution requires implementing appropriate macroeconomic policies, but there is disagreement as to which policies are appropriate. As this report demonstrates, still others believe attention must also be paid to the structure of financial markets even though that structure may be influenced significantly by macroeconomic policies.

---

[119] Statement of Henry Kaufman, *Financial Restructuring and Takeover Activity*, *op. cit.*, June 5, 1985, pp. 385–386.

[120] Kaufman, *op. cit.*, p. 7.

Another view of the problem of risk and how to solve it was offered by Stephen J. Friedman:

> If you are comparing them to equity securities, they are safer than almost any equity security one can imagine, provided that the pool is adequately selected. It seems to me [that] whatever problems there are, [they are] the type of problems that are easily dealt with, with conventional regulatory tools, with disclosure, with significant liability backing up disclosure obligations, and bars on self-dealing to the extent that is a problem. (*The Expanding Securities Markets: The Economic and Regulatory Issues*, *op. cit.*, p. 333.)
>
> • • • • •
>
> What the SEC ought to be doing is sitting down with an intelligently selected group of people who are interested in it on both sides—purchasers, investors, banks and others—and talk about the best way to regulate these pools, what rules they ought to be subject to, and how to make the regulatory system work so that it is possible to bring these things to market on the one hand, and not sacrifice important regulatory objectives on the other. It just needs to be adjusted a little (*Ibid.*, p. 343).

These views are not mutually exclusive. While it is possible that effective implementation of any one would contribute to an improvement in U.S. economic performance, a coordination of all three of the proposed strategies might produce even better results. Some would argue, in fact, that there is a mutual dependence between financial structure and macroeconomic policy and that, to some extent, the failures attributable to both reflect the failure of policy makers to perceive that linkage.

The impact of macroeconomic policy on financial markets is evident from an analysis of financial developments in the 1980s. But financial structure and regulation also played a role in those developments. While macroeconomic policy exerts a powerful influence on the overall level of credit flows and their distribution between the public and private sectors, financial structure and regulation were no less powerful in terms of their influence on the distribution of credit among private borrowers. The regulatory and structural framework for the financial system is, therefore, a critical factor in ensuring that financial resources are put to productive uses.

Major changes in the structure and regulation of the financial system have taken place over the last two decades with a marked acceleration in the rate of restructuring in the 1980s. For the most part, there was very little evaluation of how these changes would affect the economy. With the benefit of hindsight, recent evaluations by financial analysts suggest that it is now possible to discern some linkage between developments in the financial system and the economy.

If and when these linkages can be established with the degree of certainty necessary for inclusion within the body of accepted economic theory—if they achieve a theoretical status comparable to that of the theory that links competition and efficiency—evaluating changes in financial structure and regulation in terms of their impact on credit allocation and economic performance may become a more widely accepted component of policy decisions.

At present, however, decisions about financial restructuring tend to reflect either the view that market forces should determine how credit is allocated or that specific interventionist strategies are needed to allocate credit to sectors that are disadvantaged in a wholly competitive environment because of the price of credit or the borrower's size or geographic location. Both views tend to ignore the underlying role that the overall structural and regulatory framework for the financial system plays in channeling the flow of funds from investors to intermediaries to borrowers.

As discussed in Part I of this report, these conflicting views of the role of financial structure and regulation are not new. But a degree of polarization has occurred in recent years that has tended to institutionalize the conflicts between them. Elements in current financial restructuring efforts reflect both views in ways that undermine the objectives of either. This, in turn, reflects the absence of a consensus on how the financial system should be restructured and what restructuring should seek to accomplish.

Over the past fifty years, the regulatory framework devised by Congress has sought to strike a balance between the legitimate entrepreneurial aspirations of private financial institutions and their fiduciary responsibilities. That balance has been based on a consensus view that the financial system plays a unique role in the economy. As the debate has moved further away from that view of the system's function and more emphasis has been placed on entrepreneurship than fiduciary responsibility, it has become more difficult to construct the necessary consensus that will enable financial restructuring to proceed in a more orderly and coherent fashion. There appears to be substantial agreement that the legal and regulatory framework for the system is in disarray; but no apparent agreement on how it should be restructured. If that is the case, the primary policy concern for Congress is to discover—or rediscover—the basic principles around which a consensus on financial restructuring can be formed.

PART III: PROTECTING CUSTOMERS OF FINANCIAL INSTITUTIONS

BLANK PAGE

INTRODUCTION AND SUMMARY

A primary objective of financial regulation is customer protection. As discussed in the previous section, all other major regulatory objectives are interrelated, implicitly or explicitly with this central goal. But there are some strategies that are more directly targeted toward customer protection than others.

This section examines regulatory schemes that are explicitly intended to protect customers at the expense, if necessary, of the institution, as well as regulatory schemes that are designed to ensure the soundness and competitive position of institutions for the sake of their customers and the communities they serve.

The first chapter examines the implications for customer protection of various disparities in regulatory strategies intended to ensure the soundness of financial institutions. It outlines recent changes in the structure and regulation of financial institutions and attempts to assess ways in which the exploitation, the expansive interpretations of Federal regulators and competitive actions by individual states—have undermined the protection offered by soundness regulation.

The second chapter explores the regulatory scheme that protects investors in securities markets. It focuses on the role that disclosure plays in that regulatory scheme, outlines the reasons for exempting depository institutions from disclosure and the implications of disparities in disclosure requirements for investors, and discusses arguments for and against increased disclosure for financial institutions and for harmonizing U.S. and foreign investor protection schemes to accomodate the growing internationalization of capital markets.

The final chapter provides an overview of deposit and other insurance and guaranty programs for customers of financial institutions and beneficiaries, attempts an assessment of their adequacy, outlines some of the concerns about the conflicting goals of deregulation and insurance protection and some of the difficulties involved in reconciling the explicit protection offered by insurance with the greater risk implicit in the market discipline imposed by deregulation.

The discussion in this section necessarily points up differences in the applicability of regulatory schemes for different types of financial institutions, functions and markets. For example, the final chapter, on insurance programs, outlines the differences between deposit insurance funds, the Securities Investor Protection Corporation, state insurance guaranty funds, and the Pension Benefit Guaranty Corporation. The second chapter examines differences in the applicability of disclosure to depository institutions and all other securities issuers, and the first examines an even wider array of regulatory disparities among institutions and markets.

In general, the various arguments examined in this section suggest that customer protection remains the bedrock of confidence in the financial system. Nevertheless, customer protection has been weakened by changes in financial structure and functions. Disparities in regulatory treatment have become more obvious because the consolidation of institutions and functions has undermined the rationale for differences in approach. Efforts to restore customer protection to previous levels—or even to maintain the current level—may require new regulatory strategies. It may also require a more uniform approach to regulation. If so, the restructuring effort must confront some very difficult problems—for example, the risk to insurance programs and to confidence of continuing to insure financial functions that are integrated with functions that are not now insured or that have less coverage; the risk to confidence posed by disclosure of the financial condition of depository institutions, and the risk to insurance programs and confidence posed by permitting or encouraging a further proliferation of disparities between state and Federal regulation.

These problems cannot be resolved merely by shifting regulatory roles among existing agencies. Changes in the content of regulation must be considered in addition to changes in regulatory jurisdictions. Some important changes in regulatory strategies are already occurring as the new focus on responses to these and other initiatives emanating from Federal regulatory agencies support the view that the current process of restructuring has imposed new strains on the shared responsibility of states and the Federal government for financial regulation—the dual regulatory system.

Some developments support the arguments of those who urge immediate action by Congress to assert its prerogatives in the restructuring process. But they also suggest that the focus of Congressional action should not be limited to defining the functions of financial institutions. Although the legislation adopted by the Senate in September, 1984, contained some proposals for adaptive regulatory strategies—most notably in response to the risks to insurance funds posed by brokered deposits—and the House and Senate Banking Committees began evaluations of deposit insurance programs in 1985, a broader and more careful assessment of the substance and effectiveness of all regulatory strategies related to customer protection is needed. Otherwise—as has been the case with respect to defining the structure and functions of financial institutions—the major decisions are likely to be made outside Congress. If so, the process of adapting the regulatory framework to changes in institutional structure and functions is likely to prove as piecemeal, *ad hoc* and potentially destabilizing as has been the process of restructuring itself.

CHAPTER 1: REGULATION TO ENSURE SOUNDNESS AND FIDUCIARY STANDARDS

INTRODUCTION: OBJECTIVES AND PROBLEMS

The current financial regulatory structure in the United States evolved in the 1930s out of the debris of losses and failures associated with the Great Depression. The response reflected a widespread perception that financial institutions had failed to meet their fiduciary responsibilities. Many believed then, as now, that conflicts of interest and the concentration of financial resources resulting from the involvement of banks in securities activities were at the root of the problem.[1] Revelations of excessive and imprudent loans by banks to their securities affiliates, unwise risk-taking by affiliates and other questionable financial practices, as well as loss of confidence by bank depositors, contributed to the climate in Congress that resulted in reinstatement of the separation of commercial and investment banking and the creation of a new structural and regulatory framework for the financial system.[2]

The legislation enacted in the 1930s sought to protect investors, depositors and policy holders by segregating the financial system into separate categories of institutions with regulation by industry function. This structure was designed with the goal of ensuring safety and soundness by preventing conflicts of interest and excessive concentration within the financial system. The regulatory scheme applied to each industry category provides different types of specific customer protections which reflect the different functions of the industries, different degrees of risk associated with each type of financial investment, and different expectations of customers. In turn, customers' perceptions of risk associated with each financial institution reflect the role the institution traditionally has played in the economy and the anticipated protections provided by the regulatory scheme governing its operations. Each protective scheme has included both preventive and compensatory devices intended to assure the soundness (the avoidance of insolvency) of the institution and the safety of the investment. As explained by former SEC Commissioner Bevis Longstreth:

> Soundness regulation includes restrictions on the competitive environment in which financial intermediaries operate, portfolio restrictions on both the asset and liability side, prohibitions against self-dealing and regulation of conflicts of interest.
>
> Post-failure mechanisms include such federal entities as the Federal Deposit Insurance Corporation for bank cus-

---

[1] Harvey L. Pitt, Thomas P. Vartanian, David L. Ansell, "SIA v. Comptroller: Veiled Victory for National Banks?", *The Legal Times*, November 14, 1983, p. 20.

[2] *Ibid.*, 30. For a further discussion of these developments, see Part I, Chapter 2.

> tomers, the Securities Investor Protection Corporation for broker-dealer customers, and the Pension Benefit Guaranty Corporation for pension plan beneficiaries under ERISA, as well as the state-established guaranty funds for insurance policyholders.[3]

Therefore, financial customers generally expect their deposits and savings to be protected by the soundness of depository institutions as well as by deposit insurance, their long-term savings and insurance premiums to be prudently invested by pension funds and insurance companies, and their direct investments in securities to bear potentially greater risk, but also yield greater profits.

The realities of the financial services industry in the 1980s do not conform to the segregated structural and regulatory functions described above. The major barriers separating the banking and securities industries and banking, insurance and nonfinancial companies—the Glass-Steagall and Bank Holding Company Acts—are being bypassed by a proliferation of new financial products and services, by mergers and acquisitions, by imaginative exploitation of loopholes on the part of financial institutions, by expansive interpretations of existing law by Federal regulators and by changes in existing law enacted by the States. Even court rulings reveal conflicting interpretations of the definition of traditional banking functions.[4]

As the rate of change in the financial services industry accelerates, the blurring of financial functions and products may erode the effectiveness of protective strategies. Many of the new financial products appear to be functionally equivalent to the customer although they have been introduced by institutions in different industry categories that are subject to different regulatory schemes and, therefore, offer differing degrees of regulatory protection. For example, money market mutual funds, cash management accounts, and NOW accounts may appear similar in function and structure, but differences in regulatory jurisdiction significantly affect the protective mechanisms that apply to each.

The proliferation of overlapping financial instruments and functions has been accompanied by a multiplication of regulatory conflicts, gaps and overlaps.[5] Figure 3 provides some indication of the multiplicity of regulatory agencies and their overlapping jurisdictions. As SEC Chairman John S. R. Shad has noted, regulatory jurisdiction over financial markets is exercised by 10 Federal agencies, at least 50 state agencies, and over 20 self-regulatory organizations.[6] The reality is that, "Banks, S&Ls and securities firms compete under different tax, regulatory, and financing rules, administered by different federal and state agencies." [7] Many of these regulatory disparities have existed since the 1930s, but they are increasing daily. As a result, the structure of American financial law which, as the Committee on Government Operations notes, "has long been renowned for its lack of crystal clarity" is no longer "able to avoid being shrouded nearly from top to bottom in litigation." [8] And, it is becoming more apparent that in the financial services industry, "competitive advantages increasingly turn on regulatory classifications rather than on the economic merits of financial products and services." [9]

---

[3] Longstreth, *The FDIC Securities Proposal and Related Issues; op. cit.*, p. 87.

[4] Moreover, as a 1984 report by the Committee on Government Operations notes, ". . . judicial resolutions . . . almost invariably only deal with a specific part of the problem and, based on an examination of the precedents involved in current litigation, usually leave numerous serious questions unanswered" (*Confusion in the Legal Framework of the American Financial System and Services Industry*, 37th Report by the Committee on Government Operations, U.S. House of Representatives, 98th Cong., 2nd Sess., April 24, 1984, p. 9).

[5] Shad, *The FDIC Securities Proposal and Related Issues, op. cit.*, p. 15.

[6] *Ibid.*, p. 15.

[7] *Ibid.*, p. 18.

---

[8] *Confusion in the Legal Framework of the American Financial System and Services Industry, op. cit.*, p. 2.

[9] Shad, *The FDIC Securities Proposal and Related Issues, op.cit.*, p. 15.

The result of this regulatory melee is that customers of financial institutions may not always be sure what they should expect when choosing an investment instrument in terms of risk, protection and insurance; that the current environment of regulatory fragmentation has increased pressure on regulatory agencies to relax, rather than improve, customer protection in order to allow their industries to compete, and has encouraged movement from one regulatory jurisdiction to another.[10] These deregulatory initiatives present regulators with a paradox:

> As competitive restraints are relaxed, banks and other financial institutions necessarily become exposed to greater risks. Yet, deregulation often involves abandoning precisely those regulatory devices designed to promote soundness.[11]

Thus, the net result may be a system of regulation which is decreasingly effective in achieving its stated goals and objectives.

The following discussion focuses primarily on the current regulatory environment. It begins by outlining the existing regulatory approaches that apply to different financial functions. Subsequent sections discuss some of the regulatory gaps and disparities that have emerged in the 1980s as a result of institutional and product changes and widening differences between Federal and state standards relating to the powers of depository institutions.

This chapter does not analyze the various proposals for adapting the regulatory framework to changes in financial structure and the environment in which services are offered since the issues that have generated these proposals (and most of the proposals themselves) are discussed elsewhere.[12] Its purpose is to present evidence of disparities between existing regulatory strategies and the realities of the marketplace—disparities that urgently require clarification if, as the Committee on Government Operations argues, "the federal agencies are to continue to oversee the safety and soundness of the financial system in a changed business, consumer, communications and technological climate." [13]

DIFFERENCES IN REGULATORY APPROACHES

Financial institutions act as intermediaries helping customers achieve their desired investment positions. Customers can choose investment strategies in terms of risk, the yield on the investment, insurance coverage provided, the degree of direct regulation of the institution offering the investment instrument, and the types and extent of investor protection provided.

As already noted, jurisdiction over U.S. capital and credit markets is shared by numerous Federal and state agencies. Regulators of financial intermediaries employ a number of techniques to protect customers of financial institutions from loss: regulation of the amount and types of information required to be disclosed to the public; restrictions on (or the establishment of criteria for) advertising of intermediary services; direct management of intermediaries' risk exposure by restrictions on geographic and product lines or asset and liability powers; and either direct supervision of intermediaries or reliance on self-regulatory organizations (SROs).[14] Turning to the broad industry groups, the ways that different combinations of these investor protection techniques are employed clearly reflect perceptions of differences in function and risk.

---

[10] Longstreth, *The FDIC Securities Proposal and Related Issues, op. cit.*, p. 100.

[11] *Ibid.*, p. 100.

[12] For example, functional regulation and proposals to require that different financial functions be conducted by separate subsidiaries are discussed in Part II, chapter 2; strategies for preventing conflicts of interest in consolidated financial services firms are discussed in Part II, chapter 3; the role of disclosure in containing risk is discussed in Part III, chapter 2, and proposals for changes in insurance coverage are discussed in Part III, chapter 3.

[13] *Confusion in the Legal Framework of the American Financial System and Services Industry, op. cit.*, p. 6.

Securities market regulation

Strategies for protecting securities investors rely primarily on public disclosure, prevention of fraud and maintenance of orderly markets. The emphasis on disclosure in securities regulation is related to the greater degree of risk involved in buying, selling and holding securities. In addition to extensive disclosure requirements, the SEC has broad authority to regulate the securities markets by requiring registration of securities traders; by establishing advertising criteria; by requiring compliance with rules relating to capital adequacy and margin requirements; and by conducting onsite examinations. The SEC exercises its authority through a combination of reporting requirements, oversight of SROs and direct supervision. Investors also are protected by the Securities Investor Protection Corporation (SIPC) against losses incurred when a brokerage house becomes insolvent.

Self-regulatory organizations (SROs) play a significant role in the regulatory framework governing securities markets. Among the more important SROs are the various exchanges (*i.e.*, the New York Stock Exchange, the American Stock Exchange and others), the National Association of Securities Dealers (NASD), the Municipal Securities Rulemaking Board, the National Futures Association and others that oversee specific segments of the market. The SROs make rules and monitor trading activity—functions that make securities regulation effective in maintaining orderly markets.

Depository institutions

Regulators of depository institutions are concerned primarily with the soundness of the institutions they regulate. While investors are protected by deposit insurance, soundness regulation has been viewed as necessary to protect the viability of the insurance funds. Techniques employed by regulators of depository institutions include limitations on the instruments and services offered, geographic restrictions, issuance of rules and regulations regarding corporate structure and practices, and performance of onsite examinations.

Disclosure has not been a key element of the depository institutions regulatory system largely because of the extent of direct regulation, but also because of fears that disclosure may be destabilizing in cases where institutions are experiencing financial difficulties. Commercial bank trust departments are also supervised by depository institution regulators and must comply with fiduciary standards to ensure that the customer and the institution are protected. Trust assets are only insured if they are invested in insured deposit accounts.

---

[14] The discussion of these techniques is based upon the "Survey of Investor Protection and the Regulation of Financial Intermediaries," Study by the Staff of the U.S. General Accounting Office, July 13, 1983.

Insurance companies

Most users of financial services have some familiarity with the regulatory context in which the securities and banking industries operate. Fewer are familiar with the framework for insurance regulation—in part because insurance is the only major financial service sector not directly regulated by the Federal Government.[15] In 1945 Congress enacted the McCarran-Ferguson Act which reaffirmed the traditional authority of the States to regulate the private insurance industry and exempted that industry from the antitrust laws. The United States is atypical in this respect as it is probably the only nation that does not regulate insurance at the national level. On the other hand, the Federal Government itself is a major insurance provider, having instituted compulsory social security and unemployment insurance systems, insurance for defined benefit pension plans and securities firms and voluntary coverage for bank and thrift deposits, mortgages, crops and other activities and institutions. In addition, the Federal Insurance Administration was created in 1968 to enable government to provide coverage (including flood, crime and riot reinsurance) that private insurers were unable or unwilling to offer.

The McCarran-Ferguson Act "implies" a Congressional oversight responsibility to periodically assess the adequacy and effectiveness of State insurance regulation. The Act does not specify this directly nor does it establish any regular time or procedure for review. It has long been the subject of criticisms and the target of a number of legislative initiatives that would eliminate or modify its provisions. Nevertheless, the McCarran-Ferguson Act has never been changed in any way. Although it is unlikely that the Federal government will assume the major role in insurance regulation, the threat of Federal regulation whenever the States fail to perform adequately has the benefit of being a constant impetus for improving state insurance regulation.

The insurance department in each state is part of the state government, in that the Commissioner (who is the head of the office) reports to the Governor[16] and is not always bound by the decisions of his predecessor.[17] This flexibility provides ample opportunity to change regulations. With 50 independent insurance departments, however, it often also results in an absence of uniformity that leads to duplication, complexity and inefficiency. The fact that the insurance industry—not a state-contained business—is regulated on a non-uniform basis at the state level may not be compatible with the prevelance of large, national insurance companies which dominate the industry.

---

[15] A more extensive discussion of insurance than securities or banking regulation is provided here to assist readers unfamiliar with the subject and to provide background for the discussion of state insurance guaranty funds in Part III, Chapter 3.

[16] Generally, the Insurance Commissioner is appointed by the governor—except in eleven states, where he is an elected official.

[17] Insurance experts point out that the problems the industry is facing—23 companies were declared insolvent in 1985, 19 in 1984 and 15 in 1983—"raise the question of whether state regulators have the ways, the means and the will to regulate insurance companies." They add that, "More [troubles] are expected this year as a result of the continuing insurance crisis, which has been blamed on a combination of poor returns on investment, record claims payments and bad management." (Molly Sinclair, "The Insurance Regulators", *The Washington Post*, April 6, 1986, p. A16.)

Insurance companies are free to cross state lines, provided they meet the requirements in each jurisdiction.[18] The large number of active insurers and the ease by which they can enter the market complicate the task of monitoring their financial condition. The dilemma posed by state regulation of an industry comprised mostly of nation-wide companies also adds to the difficulties of insurance regulation. To reduce waste and avoid duplication in the examination process, the National Association of Insurance Commissioners (NAIC) has established a system that coordinates examiners from the various states where the insurer does business.[19] The NAIC, after engaging in extensive studies, has moved to improve the financial condition surveillance system for the insurance industry.[20]

The principle objectives of private insurance regulation are to "assure fair competition, monitor the solvency of insurers, help make insurance available to those who need and are entitled to coverage and assure equitable treatment of the insuring public." [21] Insurer solvency is by far the most important goal in the United States, as well as in Japan, West Germany, Sweden, Canada and the United Kingdom. The ability of insurers to carry out provisions of contracts depends upon such factors as efficient operation of the insurer, the selection of satisfactory risks, the determination of proper premium rates, and the prudent investment of adequate reserves.

Insolvency is generally defined as that financial condition in which the insurer's assets are less than its combined liabilities minus capital and surplus.[22] Reserve and investment requirements are designed to bring an element of conservatism to the financial activities of insurance companies. There is, however, considerable subjectivity in the determination of the size of reserves. The fact that it is impossible to know for certain the future obligations of property-casualty insurers adds to the uniqueness of that industry.

---

[18] Even though an insurer is required to be licensed separately in every state in which it conducts its business, the criteria for most states is based almost exclusively upon the insurer's ability to meet the standards for capital and deposit and surplus requirements for that state. The capital and surplus requirements are the same for domestic and foreign insurers. The deposit, held in trust with the State Treasurer, is a very insignificant amount and provides little protection for policyholders. In recent years, laws have been enacted to create guaranty funds to protect policyholders from unpaid claims of insolvent insurers, as discussed in Part III, Chapter 3.

[19] The nation is divided into six zones and the chairman of each is responsible for assigning examiners from his zone.

[20] As part of that effort, NAIC organized the Conference of Insurance Legislators (COIL), an independent public interest group, in 1969. It was established in response to criticisms directed at nonuniformity in state insurance regulation, with the thought that including legislators, committee staff people, and government officials on the board would add credibility to its coordinating efforts. Although an important objective of the Conference is to assist the NAIC in acquiring a more dominant role in insurance legislation and regulation and to attempt to head-off Federal legislation and regulation of insurance (sometimes by going to Congress with its own legislative initiatives) the COIL also works to enhance insurance departments, conducts research, disseminates information, and provides educational programs.

[21] Robert I. Mehr, *Fundamentals of Insurance*, Richard D. Irwin, Inc. Homewood, IL, 1983, p. 494.

[22] "A Comparative Analysis of Government Regulation of Property-Liability Insurance in Selected Countries and the United States", prepared by the Congressional Research Service for the use of the House Committee on Small Business, March 1980, p. 105.

The examination process and analysis of financial filings are key steps in determining if a company is meeting prudential standards.

The data that state regulators use to judge the health of the nation's insurance companies are being subjected to increased scrutiny.[23] And since the companies themselves are the source of the data, some states are imposing tougher financial reporting rules. Massachusetts, the first state to impose audit rules, implemented them in the mid-1970s. New York, Pennsylvania, Illinois and Wisconsin are others that require a licensed property-casualty company to file statements showing that the data have been audited by independent certified public accountants. Insurance companies also send their financial statements to the National Association of Insurance Commissioners (NAIC) headquarters, where they are computer programmed to determine if closer examination is necessary. In 1984 the NAIC found 100 of 5000 companies it monitors in bad enough condition to require desk audits.[24] Unlike the disclosure mechanisms of other financial and nonfinancial industries, this list of companies is not made public. Even the Independent Insurance Agents of America were denied access to the information.[25]

An additional hindrance to effective insurance regulation is the mass of complicated transactions that often occur between subsidiaries of an insurance holding company. Clearly the state regulators have authority over the insurance subsidiaries, but that, in itself, has not been adequate. Therefore, the NAIC has adopted a rule requiring an insurance holding company to get a regulator's approval before shifting more than five percent of a company's net worth in an intra-company transaction.

It is hoped that this rule will deter the loose internal accounting practices that typified the Baldwin-United insurance holding company bankruptcy in 1983.[26] However, the fact that so large a segment of the property-casualty industry is owned by, or affiliated with, nonfinancial companies poses a particular problem for insurance regulators. Their knowledge of the business of nonfinancial affiliates is necessarily limited. But lacking such knowledge—of the oil business, for example, in the case of Charter—may make it more difficult to assess the prospective solvency of an insurer, as well as police its transactions with affiliates. Even with the five percent rule, monitoring will be difficult if affiliations between insurers and securities firms proliferate given the complex transactions that may occur.[27] And such problems will arise in other industries, too, as consolidation picks up momentum.

---

[23] The fact that the property-casualty insurance industry has not experienced an underwriting profit since 1978 (David Whiteman, "Property-Casualty Insurance Market Operation", Congressional Research Service Report #85-629E, March 20, 1985, p. 10) has resulted in constant criticism of the entire regulatory structure for that industry. In 1984, this industry suffered its first net operating loss since 1906 (the year of the San Francisco earthquake) which totalled $3.55 billion (Monica Roman, "Property and Casualty Insurers Hope to Recover After Worst Year Since 1906", *Investors Daily*, February 1, 1985, pp. 1 and 7). Excess capacity, pricing wars, and inadequate reserves contributed to the property-casualty insurance industry's difficulties as discussed in Part III, Chapter 3.

[24] An example of one company's situation is illustrative of the degree of disorganization: When a New Jersey insurance company failed, the regulators found it "so sloppily managed that its records are in such a state of disarray that it is impossible to identify all its policyholders so that notices can be sent to them." (James Nolan, "New Jersey Demands Better Data of Insurance", *Journal of Commerce*, January 17, 1985, p. 1.)

[25] James Nolan, "Bookkeeping Methods of Insurers Subjected to Increasing Scrutiny", *Journal of Commerce*, February 6, 1985, pp. 1 and 7.

[26] James Nolan, "Regulating: A Catch 22 Exercise", *Journal of Commerce*, February 7, 1985, p. 6.

Like other financial services sectors, the insurance industry is going through a process of restructuring that may result in increased pressure to change the existing regulatory framework. As one analyst observed:

> In the future, change may be thrust upon the industry and State regulators alike as the Congress comes to grips with the public policy implications of the restructuring of U.S. capital markets. One issue in particular, is how to reconcile a traditionally State-regulated industry, like insurance, with the federally regulated banking and securities industries.[28]

THE PROLIFERATION OF REGULATORY DISPARITIES

A detailed discussion of the innumerable regulatory gaps and disparities created by recent developments in the financial services industry is clearly beyond the scope of this report. The following examples focus on those disparities that appear to impact most significantly on the current structural and regulatory framework for the financial system.

Limited purpose banks

The advent of "nonbank" banks is perhaps the most vivid example of loophole exploitation and of the structural and regulatory disarray that has developed within the financial system. For purposes of the Bank Holding Company Act, a bank is defined as an institution which accepts demand deposits and makes commercial loans.[29] By divesting a bank of either its demand deposits or its commercial loan portfolio, an institution is created which no longer is a bank for the purposes of the Act.[30] In this way, nonbanking institutions (such as securities firms, insurance companies and retail and manufacturing organizations) are able to offer additional financial services, including Federally insured deposit services, which were previously limited to traditional depository institutions.

Exploitation of the "nonbank" bank loophole also was seen as a vehicle that would enable bank holding companies to circumvent Federal prohibitions against interstate banking. As an article in *The Wall Street Journal* commented, a proliferation of nonbank banks "could result in an alternative banking system beyond the reach of the Federal Reserve . . ." [31] Others are more concerned about the effect that the nonbank bank phenomenon may have on lending patterns. For example, the National Federation of Independent Business (NFIB) has called attention to "the manner in which nonbank banks separate deposits from use of commercial credit—particularly in the form of small business loans," [32] noting a study showing that three-fourths of all bank loans to small firms were made by small and medium-sized banks, and that loans to small firms make up 95 percent of the commercial loan portfolio at small banks and 77 percent at medium-sized banks, compared to just 13 percent at large banks. The NFIB concluded that the relationship between small firms and small to medium-sized banks is indeed important.[33]

---

[27] This problem is discussed in Part II, Chapter 3.

[28] "Insurance and the Commercialization of Space", Congressional Research Service report #99-16, prepared for the Committee on Commerce, Science and Transportation, U.S. Senate, March 1985, p. 18.

[29] F. Jean Wells, "Financial Deregulation: Current Status and Legislative Issues", CRS Issue Brief IB83015, Updated April 2, 1984, p. 2.

[30] *Ibid.*, pp. 2-3.

[31] Daniel Hertzberg, "Comptroller Urges Bankers to Establish Consumer Banks Fast, Ignore Congress", *The Wall Street Journal*, October 25, 1984, p. 8.

Although the first nonbank bank appeared many years ago, there was a hiatus in their formation until the late 1960s. With the advent of interest rate deregulation in the early 1980s, a rash of applications was submitted to the Comptroller of the Currency.[34] By early 1983, firms as diverse as Gulf & Western, Chrysler Corp., and bank holding companies had acquired or formed nonbank banks. In view of the controversy over their establishment, the Comptroller declared a moratorium on further approval of applications from April, 1983 through the end of the 98th Congress, to give Congress an opportunity to close the loophole.[35] But by the beginning of April, 1985, the Comptroller had received 363 interstate nonbank bank applications since the moratorium had ended; the Comptroller's office had denied 16 applications and had granted preliminary approval to 253 nonbank banks to be operated by 58 parent companies in almost all states.[36] As of this writing however, final resolution of their legality awaits decisions by the courts.[37]

In addition to the acquisition or formation of limited purpose banks, firms have found the acquisition of a savings institution to be an attractive means for acquiring banking services. Several conglomerates (Sears, National Steel) are unitary savings and loan holding companies, which means they control only one S&L.[38] Ownership by non-depository institutions of limited purpose banks and S&Ls has generated concerns in both government and the financial community. The linking of investment and commercial banking, the interlocking of directorates between member banks and securities and commercial firms, and the movement toward *de facto* interstate banking are straining the underlying assumptions that have supported the regulatory structure since the 1930s.

Banks' securities activities

In drafting the Glass-Steagall Act Congress made a number of exceptions for bank securities activities. Banks act as trustees or custodians for individuals, and operate common trust funds and collective funds for pension plans. They act as agents for customers in purchasing and selling securities, arrange private placements of securities, manage dividend reinvestment plans, employee stock purchase plans, and offer automatic investment services. Banks also maintain investment portfolios for their own accounts, subject to certain limitations, and deal in government obligations for their own accounts, without limitations.[39]

---

[32] John Sloan, Jr., President & CEO, The National Federation of Independent Business, Statement before the Independent Bankers Association of America, Las Vegas, Nevada, March 12, 1986, p. 3.

[33] *Ibid.*, pp. 3–4.

[34] Interest rate deregulation as an impetus for exploitation of the nonbank bank loophole is discussed in Part II, Chapter 1.

[35] Hertzberg, *op. cit.*, p. 8.

[36] Comptroller of the Currency, "Summary of Non-bank Bank Applications Filed with OCC," mimeographed.

[37] In *U.S. Trust Corp. v. Board of Governors of the Federal Reserve* (85-193) petition for cert was granted by the Supreme Court, to hear a nonbank bank case that originated in Florida, and after deciding on a separate nonbank bank case in January, 1986, the Supreme Court remanded this case back to the U.S. Circuit Court. In the Dimension case the Court ruled that the Fed does not have the authority to expand the definition of a NOW account to demand deposits for purposes of defining a bank, and therefore could not impose limitations on nonbank banks.

[38] Wells, *op. cit.*, p. 4.

Depository institutions are exempted from the Securities Act for any security issued or guaranteed by the institution, and any interest or participation in a common trust fund or a qualified pension plan. They are also exempted from the definition of broker-dealer in the Securities and Exchange Act. The Investment Company Act exempts depository institutions from the definition of investment company and the Investment Advisers Act excludes them from the definition of investment adviser. These exemptions result in significant differences in regulation of similar products. For example:

Pooled investment management services are regulated in different ways and to different degrees depending on whether they are offered by banks or securities firms. In recent years, innovative new instruments have expanded the list of pooled investment services and have raised questions with respect to the regulatory umbrella under which the instruments should fall. Some new instruments have been assimilated into the regulatory structure; however, regulation in many instances is dictated by the class of institution providing the service rather than by the service performed.

Investment companies' pooled assets—stock and bond mutual funds and money market mutual funds—are regulated under the Investment Company Act, and shares in these funds are regulated under the Securities Act of 1933. Most bank commingled products, whether individual trusts or commingled pension fund assets, however, are exempt from SEC regulations. The Commission studied common trust funds in the 1930s as part of its Trust Study that led to passage of the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Common trust funds were exempted from the definitions included in these Acts and interests in such funds are partially exempted from regulation under the Securities Act on the grounds that bank funds would be regulated adequately by bank regulators.

Since 1937, the Federal Reserve Board has permitted banks to commingle small trust accounts as long as the funds were held for "true fiduciary purposes". In 1955, banks were authorized to create collective investment funds for the commingling of assets of corporate retirement plans already managed by the bank. Commingling of trust funds was permitted primarily to facilitate fiduciary account administration and not to encourage investment by the general public. Banks, therefore, have not been permitted to actively solicit public investment in collective funds, although they may generally advertise the availability of the services.

While trust departments generally act in a fiduciary capacity and function in a manner much different from that of an investment company, trust departments also pool assets of individuals and invest them at the discretion of the institution.[40] Although this function is much like that of an investment company, depository institutions' trust departments are regulated by the same regulatory agency that regulates their lending side. Disclosure requirements have been left to the Office of the Comptroller of the Currency for national banks, to state banking authorities for state-chartered banks, and to the Federal Home Loan Bank Board for savings and loan associations that offer trust services.

---

[39] *FDIC Securities Proposal and Related Issues*, op. cit., p. 74.

Disclosure requirements placed on investment companies provide much more information to investors than requirements placed on trust departments. The OCC's regulations requiring bank collective investment funds to prepare an annual financial report are the only continuing disclosure requirements for bank trust departments. Trust departments generally will provide account information if requested (except where specifically prohibited by the trust instrument), but sometimes it is the responsibility of the trustee or beneficiary of a trust to request information regarding his or her account.[41]

Under the Securities Act of 1933 and the Investment Company Act of 1940, investment companies are subject to extensive disclosure requirements designed to provide investors with material information regarding the securities offered for sale and to prevent misrepresentation, deceit, and other fraudulent acts and practices regarding securities sales. Investment companies are required to provide a prospectus which discloses all material facts of the offer and must send to shareholders—at least semi-annually—reports showing changes in investment policy. Shareholders have a right to elect the directors of the investment company and must approve any fundamental changes in investment policy, changes in the terms of investment advisory contracts and the appointment of independent accountants. An annual report, audited by independent certified public accountants, must be sent to shareholders.

Advertising by securities firms is subject to statutory requirements, as well as regulations promulgated by the SEC and self-regulatory organizations. Investment companies are limited to publishing advertisements containing yield information. Bank advertising of collective investment funds has not been subject to restrictions comparable to those contained in the securities laws.

As these differences between the regulation of pooled investment management services indicate, services regulated under the securities laws place greater emphasis on the fiduciary responsibility of the institution offering the service. As discussed above, regulators that supervise similar services offered by depository institutions are more concerned with the soundness of the institution than with how well it exercises its fiduciary responsibilities to customers of its investment management services. Customers may not be aware of the differences in regulatory protection associated with otherwise comparable services and, as the number of pooled investment management services offered by depository institutions has increased, there is increased concern that it may no longer be desirable to exempt bank commingled trust accounts and collectively managed pension funds from regulations which apply to their competitors.

---

[40] For a discussion of how well beneficiaries are served and of the concentration of assets that results from pooling bank trust and pension funds, see Part II, Chapter 3.

[41] General Accounting Office, Staff Study, *op. cit.*, p. 53.

Discount brokerage activities of depository institutions. Section 16 of the Glass-Steagall Act prohibits the purchase of stocks and securities by a bank for its own account, but permits a bank to act as agent for its customers. At the time the Glass-Steagall Act and the securities laws were enacted, it was envisioned by Congress that bank securities activities would remain merely an accommodative function.[42]

In the period 1936 to 1982, the administrative interpretations by the Comptroller of the Currency regarding Section 16 were fairly cautious, placing limitations upon the profit the bank derived from brokerage services, the solicitation of customers for these services and the extension of credit by the bank for securities purchases. Recently, however, bank securities brokerage activities have changed significantly.

On August 26, 1982, the Comptroller of the Currency (responsible for chartering and regulating national banks) approved the application by Security Pacific National Bank to establish a subsidiary, Discount Brokerage Service, to act as a broker-dealer under the Securities Exchange Act. Although investment advice would not be permitted, the subsidiary would operate as a limited-service stock brokerage concern, engaging in the purchase and sale of all types of securities, providing margin loans, and offering its services to the general public from both bank and nonbank branches throughout the country.

On January 7, 1983, the Federal Reserve Board, which regulates bank holding companies, approved the application of BankAmerica Corp., one of the nation's largest bank holding companies, to acquire Charles Schwab Corp., the nation's largest discount brokerage firm.[43] Charles Schwab's discount brokerage services include the purchase and sale of stocks and securities for customers, paying interest on customer balances, and providing margin loans and related services such as customer-directed Individual Retirement Accounts. Discount brokerage services do not include giving investment advice. The Board later amended Regulation Y to add discount brokerage to the list of activities that are considered to be "closely related to banking" and in which bank holding companies may engage.

Approval of these applications was based on reinterpretation of the Glass-Steagall Act. The Comptroller reasoned that Section 16 authorizes these services because it permits banks to purchase and sell investment securities without recourse, solely upon the order and for the account of customers. The Federal Reserve Board concluded that brokerage services are functionally similar to services traditionally provided by banks, *i.e.*, buying and selling securities as agents for trusts and other accounts managed by banks, and as permitted by statute.[44] The Comptroller also argued that discount brokerage services conducted through a subsidiary of a national bank would be permitted under Section 20 of the Glass Steagall Act which permits affiliations with firms not principally engaged in investment banking. The reasoning was based upon the Supreme Court holding in *Board of Governors of the Federal Reserve System* v. *Agnew* that differentiated between brokerage services and investment banking for the purposes of Section 32 relating to interlocking directorates.[45]

---

[42] This opinion was reiterated as recently as August, 1977 in the SEC's so-called "Bank Study" which distinguished bank brokerage activities from activities of registered broker-dealers with respect to the informal nature of the services, the general absence of advertising and the absence of commissions based on the size of transactions. *Reports on Banks Securities Activities of the Securities and Exchange Commission*, Prepared for U.S. Senate Committee on Banking, Housing and Urban Affairs, 95th Congress, First Session.

[43] Although challenged by the Securities Industry Association, the legality of the Federal Reserve Board's approval of this acquisition was upheld by the Supreme Court (*Securities Industry Association* v. *Board of Governors*, No. 83-614, 104 U.S. Supreme Court 3003, June 28, 1984).

The Federal Home Loan Bank Board (FHLBB), on May 6, 1982, approved an application by ISFA Holding Company, a corporation owned by the service corporations of 34 thrifts and the Kemper Group, to organize a joint subsidiary, INVEST, to provide securities brokerage and standardized investment advisory services. Presently, there are over 100 financial institutions subscribing to the INVEST program. INVEST offers its services through separate booths located within the thrift institutions, staffed by individuals who are dual employees of INVEST and the thrift and are registered with the SEC and the NASD. Since the services are provided through service corporations which are subsidiaries of the thrift institutions, the FHLBB held that these activities would not violate Section 21 of the Glass-Steagall Act because the services are not conducted within the same institution as deposit taking. Section 20 is not violated because it applies only to banks that are members of the Federal Reserve System.

These rulings brought about an aggressive expansion by banks and thrifts into discount brokerage. Depository institutions now offer services that are functionally indistinguishable from those offered by registered broker-dealers. They publicly solicit brokerage business and receive transaction-related compensation. Through discount brokerage services, depository institutions have sought to recover some of the losses they suffered when the largest investment firms and the new financial supermarkets lured away their high-income customers by offering new services that combined check cashing, stock trading and money market mutual funds. Some major banks—including Citicorp—are now providing investment advice using programs from third-party research organizations such as Value Line and Standard & Poor's.[46] A 1983 survey concluded that depository institutions have increased their share of the market because of consumers' trust in the institutions and their extensive branch networks rather than because of their lower brokerage commissions.

Although the focus of discussion (including the Supreme Court case involving Charles Schwab) has been the issue of whether or not discount brokerage is permissible under Glass-Steagall, another concern is the concentration of financial resources. The inherent market power of banks—their ability to accept deposits and use those deposits to extend credit—gives them significant competitive advantages in attracting a customer base. They can combine two essential financial services which other financial intermediaries are prohibited from offering. Because of their market power, banks may, in time, acquire a dominant share of the market for retail brokerage services,[47] which could undermine the role of regional securities firms in underwriting securities for small or new companies.[48] And because the capital of the largest 10 or 20 banks is so much greater than that of the top securities firms, the major banks can acquire or establish discount brokers that are better capitalized, can provide more margin loans and, thus, can potentially serve a greater number of customers. While bank entry may improve efficiency and, initially, increase competition, these gains must be weighed against a very real potential for bank domination of the market and an increase in concentration.[49]

---

[44] 12 U.S.C. Sec. 24 (Seventh), 1982.

[45] 329 U.S. 441 (1947).

[46] *Bank Letter*, a publication of *Institutional Investor*, Vol. III, No. 36, Sept. 10, 1984, p. 1.

Many banks are offering discount brokerage services through broker-dealers that are registered with the Securities and Exchange Commission. However, as of June 1985, over 1,000 banks were offering services through entities or facilities within the bank that were not registered with the SEC. Investor protections were substantially different from those covering services of broker-dealers registered with the Commission and may even have been inadequate. If investors chose their bank for brokerage services because they trusted the institution, they may have been unaware that they did not receive the full extent of investor protection afforded by Federal regulation.

Because banks are excluded from the definitions of the terms "broker" and "dealer" in the Securities Exchange Act, they are not subject to the SEC's net capital requirements or enforcement actions and are not eligible for coverage by SIPC. Federal deposit insurance covers bank deposits, but it does not extend to securities held in the bank's possession on behalf of a customer. An investor purchasing securities through a bank rather than a broker-dealer would not be protected against the loss of securities in his account as he would be with SIPC protection unless the bank had explicit arrangements with a registered broker-dealer to provide safekeeping and other traditional securities services. Had an increasing number of investors used banks not registered with the SEC to execute securities transactions, the result could have been diminishing protection overall for securities investors and less confidence in the markets.[50]

---

[47] Banks already own four of the seven largest discount brokers and, according to the Securities Industry Association, the top 10 discount brokerage firms account for 75 percent of the business. But many would agree with a recent article in the *New England Economic Review* that, because barriers to entry into discount brokerage are slight and the number of potential entrants is large, "the possibility of undue concentration in the securities brokerage market is not a cause for concern" (Steven D. Felgran, "Bank Entry into Securities Brokerage: Competitive and Legal Aspects", *New England Economic Review*, Nov./Dec. 1984, p. 29). Nevertheless, this author acknowledges that banks have significant competitive advantages:

> Bank brokers will most likely become more effective competitors than independent discount brokers. Bank brokers have the marketing advantages of greater public awareness and acceptance, in addition to greater public confidence. They also have operational advantages because they can obtain capital at lower costs, and have easier access to marketing, technological, and managerial resources. Such access can help bank brokers develop sophisticated automated systems to handle new combinations of financial services (*Ibid.*, p. 30).

But the author believes the utilization of this "greater effectiveness" will enhance competition by encouraging full service brokers to compete more effectively, and by encouraging innovation and new technologies. Moreover, he believes the benefits of consolidation and synergism will increase efficiency:

> Banks might achieve various economies of scale and offer joint products at lower unit costs. By offering brokerage services at existing offices, banks can both keep costs down and increase customer convenience. By facilitating joint purchases of brokerage and other financial services, bank broker combinations can lower customer search costs and increase efficiency" (*Ibid.*, p. 30).

[48] This issue is discussed in Part II, Chapter 4.

[49] This issue is discussed in Part II, Chapter 3.

On July 1, 1985, the Securities and Exchange Commission adopted a rule requiring banks offering brokerage services to register with the SEC to ensure that their activities would be subject to the comprehensive system of securities market regulation. In proposing the rule, the Commission stated that this action was taken in response to the expanded securities activities of banks not envisioned by the Glass-Steagall Act and the 1934 Act, and was necessitated by investor protection and regulatory concerns.[51] Under the Commission's rule, banks would no longer be excluded from the definition of "broker" and "dealer" in the Securities Exchange Act of 1934 if they publicly solicit brokerage business, receive transaction-related compensation for providing brokerage services for trust, managing agency, or other accounts to which the banks provide advice, or if they deal in, or underwrite, securities other than exempted or municipal securities, unless these activities are conducted in a subsidiary or affiliate of the bank that is a registered broker-dealer.[52] The SEC believes that the practical effect of this rule will be to force banks to conduct discount brokerage activities through registered broker-dealer subsidiaries or affiliates of the bank subject to securities market regulation and to the requirement that registered broker-dealers be members of SIPC.

"Bank-like" activities of securities firms

The securities industry has undertaken activities that resemble traditional banking activities and that, from the consumer's perspective, blur the lines between industries. They have introduced instruments such as money market mutual funds and cash management accounts (CMAs) which provide "bank-like" services, and more recently have ventured directly into banking by acquiring nonbank banks. These activities have created additional pressures for functional regulation of financial services provided by securities firms in order to prevent competitive inequities and to protect depositors as well as the soundness of the financial and monetary systems.

---

[50] Discount brokerage activities of depository institutions that were not registered with the SEC were subject to a number of regulatory schemes, depending upon which regulator supervised the institution—the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation of the Federal Home Loan Bank Board. Generally, the objectives of the regulatory schemes applied to depository institutions are the protection of depositors and the safety and soundness of the depository institutions, not the protection of securities investors.

[51] When the Commission initially proposed the rule, it did not address the legality of bank brokerage activity under the Glass-Steagall Act. Subsequently, the Supreme Court ruled in a case involving Bank of America's acquisition of Charles Schwab that bank affiliation with a discount broker does not violate Glass-Steagall restrictions. It said those restrictions are focused on bank affiliations with a securities firm principally engaged in underwriting or dealing in securities for its own account.

[52] The ABA, arguing that bank regulation is strictly reserved for national and state banking agencies and that the SEC has no authority to issue such regulation, filed suit on August 5, 1985, in the US District Court for the District of Columbia. The SEC filed their response on October 16, 1985 and it was upheld by the court on October 30, 1985. The ABA immediately appealed and requested an expedited hearing, which was denied. The SEC rule 3(b)9 was scheduled to take effect January 1, 1986, but the SEC is granting liberal exceptions during the initial period.

Money market mutual funds (MMMFs) are the most commonly known instrument in this category and many believe they were the catalyst in the recent proliferation of new instruments that blur traditional functional lines. A share in a money market mutual fund is an equity instrument which, for many consumers, is functionally equivalent to a commercial bank account that combines savings and transaction characteristics. This perception by consumers was underscored by diversions of savings from thrifts that were placed in money market mutual funds before deregulation of interest rates on deposits. Nevertheless, there are significant differences in the character and regulation of the two instruments. Unlike a bank deposit which creates a contractual relationship in which the depository institution is obligated to repay the funds deposited at par and which is covered by Federal deposit insurance, the purchase of a share in a money market mutual fund is a purchase of an equity interest in a fund which is subject to daily fluctuations in the value of its assets and is not covered by Federal deposit insurance. Among regulatory distinctions affecting their competitiveness, money market mutual funds are exempt from reserve requirements, deposit insurance premiums, interest rate limitations,[53] minimum deposit requirements and other regulations promulgated by Federal regulators of depository institutions. Thus, MMMFs offered by securities firms enjoy significant competitive advantages over bank checking accounts.

The popularity of money market mutual funds spurred a discussion of proposals for imposing additional bank-type regulations—including reserve requirements—on these instruments. The funds argued that they should not be regulated like deposit accounts because they are equity instruments that are extensively regulated under the Investment Company Act and the Securities Acts. They argued that money market funds do not violate Section 21 of the Glass-Steagall Act because the check-writing privilege is not a demand for repayment of a deposit with an intermediary, but an expedited means of redeeming shareholders' interests in a fund.

Passage of the Garn-St Germain Depository Institutions Act of 1982 created an equivalent instrument for depository institutions, the money market deposit account (MMDA), which is directly competitive with the money market mutual fund. The accounts are covered by Federal deposit insurance and have no interest rate ceilings although they are subject to requirements governing maturity and the minimum size of investment. While the debate on the issue of regulating money market mutual funds has subsided because of the large net inflows back into depository institutions that resulted from the creation of MMDAs, similar questions are raised by other new instruments introduced by securities firms.

The cash management account (CMA) serves as an alternative to having both a savings and checking account at a bank and offers higher yields for high-income customers. A CMA combines a margin account for the purchase and sale of securities, investment in one or more money market mutual funds, credit card services and a checking account maintained with a bank. This arrangement permits CMA customers to achieve a higher yield by daily sweeping of margin accounts and depositing their balances in money market mutual funds. Money market mutual fund shares are automatically redeemed to cover transactions involving the use of credit cards or check-writing privileges. Unlike a commercial bank account, a CMA may be offered anywhere in the country.

---

[53] Negotiable Order of Withdrawal (NOW) accounts and small savings accounts of less than 31 days maturity were still subject to interest rate ceilings which were 5¼ and 5½ percent (respectively) until January 1, 1986.

Several securities firms have introduced the CMA. More recently, banks have introduced "sweep accounts" that combine demand deposit accounts or NOW accounts with money market mutual fund accounts. The banks sell and redeem shares in the fund through a broker-dealer. It is argued that these bank sweep accounts are legal under Section 16 of the Glass Steagall Act because the bank is acting solely as agent for its customer.

Since CMA and "sweep accounts" offered by banks have characteristics of both deposit and investment instruments, they present peculiar investor protection and regulatory concerns. The brokerage firm version of the cash management account utilizes a bank to perform operational functions but the bank really holds no funds. The real "deposit" is held in the money market mutual fund which is not regulated like a depository institution. In the case of the "sweep account" offered by banks, the question arises as to whether the funds are being held in the form of a deposit or only as an incident to being invested—an important distinction in the event of failure of either the bank or the broker-dealer in terms of the applicability of deposit insurance or coverage by SIPC.

Moreover, these instruments raise a perplexing problem regarding the potential effectiveness of proposals for "functional regulation": under which functional category does the instrument fall? As more innovative financial instruments develop, categorization of service by functions may prove increasingly difficult.

Similarities between insurance and securities products

Single premium deferred annuities (SPDAs) have characteristics common to both insurance and securities products. SPDAs are similar to securities products in that the initial premium is paid in a lump sum and the policyholder is guaranteed a fixed rate of return. However, the liability for deferred scheduled payments (which usually begin at retirement) rests with an insurance company and thus the accumulated interest on the investment is tax free.

Witnesses at a December, 1983, Subcommittee hearing were clearly divided on the status of SPDAs as insurance or securities products. A witness from the New York Attorney General's Office, Scott Greathead, believed that the SPDAs were essentially securities. He noted that Baldwin-United's SPDAs were sold through an insurance subsidiary to escape securities disclosure requirements, and were simultaneously marketed as an insurance product through registered broker-dealers because they failed to comply with the state's insurance regulations.[54]

A different approach was taken by Harold Lasher, Chairman of the New York Assembly's Committee on Insurance. He believed the policies sold by Baldwin-United were insurance products, rather than securities, even though they were distributed through a securities mechanism. James Corcoran, the New York State Superintendent of Insurance, agreed with this view on the grounds that SPDAs contain mortality features. He argued that the Baldwin companies did not seek licensing in New York because they wanted to escape the financial oversight of the New York Insurance Department. Mr. Corcoran also commented that SPDAs were inherently good products when regulated effectively. At a subsequent hearing, SEC Commissioner Charles Cox noted that insurance annuity products are specifically exempted from the Securities Act but pose a very difficult question as to whether or not they should be defined as securities.[55]

Baldwin-United got into trouble as it continued to offer above-market rates on its SPDAs, even after interest rates went down. Prudential-Bache Securities told its retail brokers to avoid selling Baldwin-United policies in January, 1983. In April, Merrill Lynch, a creditor of Baldwin-United due to a previous, unrelated purchase, stopped selling the SPDAs altogether. Baldwin-United was in the midst of extending its bank loans after finding it impossible to meet the payments. During the month of April, Baldwin-United took in $26 million in premiums for new SPDAs and redeemed $76 million to policyholders cashing in their annuities.

In September, 1983, Baldwin-United filed for bankruptcy under Chapter 11. In October, seven major securities brokers in New York were charged with the illegal sale of annuities of two units of Baldwin-United Corp., which were not licensed to sell these products in the state. Merrill Lynch, which had actively promoted Baldwin-United's SPDAs, set aside $88 million in a reserve fund for partial reimbursement to customers who bought the SPDAs. Prudential-Bache, also concerned with its liability, followed the lead. By September of 1984, 12 of the 35 securities firms that sold Baldwin-United's SPDAs settled a class action suit and refunded $135 million to investors. Insurance companies contributed $50 million for reinvestment purposes. Brokerage firms had sold 84 percent of Baldwin-United's SPDAs and insurance companies 16 percent, as reflected in the breakdown of the reimbursement figures.

Single premium deferred annuities, many of which were sold in brokerage houses, were described as investment vehicles of guaranteed safety—initial payments would be redeemed in full. Yet little or no disclosure of Baldwin-United's financial condition was made to the investors. A regulatory approach more consistent with full disclosure would seem to have been more appropriate for a financial product containing such substantial elements of risk as those which characterized Baldwin-United's SPDAs. As Mr. Greathead noted:

---

[54] *Financial Deregulation in New York State*, hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Cong., 1st Sess., Serial No. 98-90, December 14, 1983, p. 17.

[55] *Financial Consolidation: The Emerging Regulatory Issues, op. cit.*, April 2, 1985, p. 54.

> The tremendous losses suffered by the investing public in the Baldwin-United episode graphically illustrate the unfortunate consequences that can result from the crossover of two historically distinct industries. The bankruptcy of Baldwin-United has put in jeopardy 3.7 billion dollars invested by the public in annuities issued by its subsidiaries.[56]

DISPARITIES BETWEEN STATE AND FEDERAL REGULATION

As discussed elsewhere in this report,[57] the United States has traditionally had a dual, State-Federal system of bank regulation. Although this century has witnessed an increased nationalization of financial regulation through creation of the Federal Reserve System, Federal deposit insurance systems, Federal regulation of bank and thrift holding companies, etc., the States have continued to exercise direct authority through their chartering, supervisory, and examination powers over a number of institutions for which they are the primary regulators.[58] The dual system is the result of historical accident and of adherence to the concept of federalism, the theory that embodies both responsiveness to local needs and a desire for national uniformity. In the nineteenth century, populist and agrarian interests opposed establishment of national banks for fear that they would divert funds from localities and encourage usury and speculation.[59] Two separate and independent banking systems operated in the country until passage of the Federal Reserve Act in 1913, which marked the beginning of Federal regulatory involvement with state-chartered banks. With the creation of Federal deposit insurance, the great majority of state-chartered banks came under some Federal regulatory supervision. Today, the two systems are interrelated.[60]

The cooperative State-Federal system of regulation has functioned relatively well, permitting accommodation of local differences within the limits of commonly-shared regulatory objectives. However, the structure on occasion has caused serious problems when the commonality of regulatory objectives has broken down. Most notably, state easing of restrictions on the permitted activities of banks during the 1920s encouraged banks to switch from national to state charters, forcing an easing of geographic and product restrictions at the Federal level as well.

Recent state initiatives. While the addition of new Federal regulatory structures over the last 70 years has tended to establish a Federal standard for regulation, recently the pendulum has begun to swing in the opposite direction. As the Committee on Government Operations noted, this shift reflects ". . . the spreading disintegration of a longstanding, tacit accord between the national government and the states . . . to the effect that the powers of depository institutions franchised by both levels in the federal system would be quite similar." [61]

---

[56] *Ibid.*, p. 33.

Mr. Greathead added that, "The Baldwin United episode might have been avoided if securities' brokers had made the same kind of disclosure to investors that are required in ordinary securities transactions."

[57] See Part I, Chapter 2.

[58] F. Jean Wells, *Depository Financial Institutions: Regulatory Restructuring?*. Congressional Research Service, Report no. 84-139E, August 14, 1984, p. 39.

[59] James J. White, *Teaching Materials on Banking Law*. St. Paul, MN, West Publishing Co., 1976.

[60] Raymond Natter, "Formation and Powers of National Banking Associations—A Legal Primer," Congressional Research Service, the Library of Congress, May 10, 1983, pp. 1-3.

Increasing pressures are being applied by financial institutions on state legislatures and by state governments on Federal regulators to ease regulatory restrictions. Many states, especially capital-poor states, have acted to attract out-of-state business—and hence more jobs and tax revenues—by easing restrictions on financial institutions chartered in their states. Some states are leading the charge in financial deregulation by empowering their banks and savings and loan associations with authority exceeding that provided under federal law. A major thrust of this authority is to widen the range of investment opportunities available to state-chartered banks and thrifts. According to the Kentucky Commissioner of the Department for Financial Institutions:

> Banks are now forced to compete with larger well-financed and well-managed corporations which operate without the regulatory restrictions with which the banking industry must deal. Many corporations make a 7 percent to 10 percent return on assets, but banks are glad if they make 1 percent.[62]

Moreover, State bank commissioners and legislators indicate that it is their duty to move in directions they believe will benefit the economy and the consumers of their states. Recent developments suggest, however, that one result of states' deregulatory push will be a further erosion of the traditional barriers between banking and commerce.

With states willing to compete for financial business if it brings jobs and revenues, banks may shop among states for the most favorable regulatory climate. A major impetus for states with large banking interests such as New York to extend new bank powers to state banks came from a strategy devised by several large banks. After approaching South Dakota and Delaware, and offering incentives if those states would amend their laws, banks were able to initiate the momentum toward banking deregulation. For example, legislation was passed in South Dakota which permitted bank insurance underwriting. The South Dakota legislation would permit state-chartered banks to engage in a full range of insurance activities either directly or through a subsidiary. Out-of-state bank holding companies would be permitted to acquire such a bank, as long as their activity did not attract business away from state insurance companies and agents. Consequently, money-center bank holding companies could purchase a state-chartered bank in South Dakota and engage in insurance activity in the other 49 states.

---

[61] *Confusion in the Legal Framework of the American Financial System and Services Industry, op. cit.*, p. 8.

In further comments on this issue, the Committee report states:

> Until recently, state governments roughly have paralleled national standards as to what they allow their depository institutions to do. They have often varied from Federal norms in some areas, such as the legal loan limits of institutions chartered under their authority. Indeed, most Federal statutes governing financial institutions have specifically and liberally acceded to a broad latitude in the states for the powers they might grant financial institutions the states might charter. However on the whole, the States have hewed to base-line federal standards. Yet, in the last several years, economically key states, such as to name but two, California and Florida, have permitted depository institutions which they franchise to have substantially greater powers and rights than those statutorily permitted to depository institutions licensed by the federal government (*Ibid.*, p. 8).

[62] "Bankers Seeking New Investment Areas," *American Banker*, September 28, 1984, p. 3.

The thrust of this argument is, however, open to question. Because banks (and other financial institutions) have lower capital-to-asset ratios (are more highly leveraged) than nonfinancial corporations, some would argue that return on equity rather than on assets is the appropriate measure of profitability.

After securing these changes, banks were able to go back to their home states (New York, for example) and threaten to move their operations elsewhere unless the states followed the precedents set in South Dakota and Delaware. The result has been a movement towards deregulation in state banking laws, as states moved to hold onto their existing institutions and attract new ones. The liberalized bank powers offered by some states also appealed to many federally-chartered banks, some of which indicated interest in switching to state charters.

Expanded State powers for depository institutions

Several states have relaxed their restrictions on investments by savings and loan associations primarily to help restore the health of thrift institutions which suffered severely during the era of high and volatile interest rates. Deregulation has freed the thrift industry from ceilings on the interest they can pay their customers and many restrictive guidelines on where they may invest. The Garn-St Germain Act (P.L. 97-320) expanded the activities that thrifts may engage in through their service corporations in some limited ways, but many states have further expanded these activities.

California, for example, has relaxed investment restrictions, as well as restrictions on ownership of thrift institutions. In the past, ownership restrictions required a minimum of 400 shareholders and prohibited real estate developers from sitting on S&L boards to prevent conflicts of interest—*i.e.,* directing money into their own projects. Since passage of the new law, a real estate developer may start his own association, own its entire stock and face no restrictions on board appointments. Rules against insider transactions can be circumvented by transferring activities to the service corporation which was given expanded powers by the law. These new activities include making commercial loans, offering brokerage services, investing in stock and syndicating real estate projects.

The change in California law has brought new capital and new entrepreneurship to the thrift industry in that state. However, the expansion into nontraditional investments may have consequences for Federal taxpayers since the thrifts are backed by the Federal insurance fund, the FSLIC. The fund has little choice but to approve most of the applications to establish these new S&L's that seek profits under the less restrictive investment guidelines.[63]

---

[63] Commenting on this issue, the report of the Committee on Government Operations states:

> The widening disintegration of this unspoken federal/state concordant challenges the primacy of the federal government's role in setting policy for the permissible boundaries of investment assets and activities of depository institutions in which that govern-

Continued

However, many fear that a sudden downturn in the real estate market could bring a new string of failures in the thrift industry and prove to be costly to the FSLIC.

States' expansion of thrift activities has not gone unnoticed at the Federal level. The House Banking Committee marked up legislation in June, 1985, to close the nonbank bank loophole and to provide for regional banking compacts with a five-year national trigger. In the aftermath of Ohio and Maryland thrift crises, the Committee adopted a section addressing the proliferation of state-chartered thrifts' powers. That section confers on the Federal Home Loan Bank Board (FHLBB) new authority to prohibit, by regulation, business activities of state-chartered thrifts which the Board determines to be "an improper incident to the operations of insured institutions, or detrimental to the interests of savings account holders therein." Activities permitted for federally-chartered thrifts are expressly preserved.

In a follow-up letter to Members of Congress, dated June 24, 1985, Edwin Gray, the chairman of the FHLBB explained the Board's view:

> Again I want to stress that the Bank Board supports the dual system, but we also support a rational system. And the dual system, as it has evolved in the last several years, has rapidly abandoned any claim to a rational nexus between the powers of state thrifts and the purpose of the federal network of regulatory benefits expressly created to nurture home financing. I believe that this development is one which Congress never contemplated or approved, and which it must act swiftly to correct in order to preserve the integrity of the federal thrift regulatory framework, and FSLIC insurance.
>
> The dual federal-state thrift system was conceived in a far more restrictive and highly regulated environment, in which the range and variation of activities permitted for both state and federally-chartered thrifts was relatively limited. Indeed, for many years, until the early 1980s, there was little diversity between state and federal thrift authorities, and a relative balance was generally maintained through state 'parity-with-federal-authorities' laws.
>
> New competitive factors and rate deregulation in a volatile economy, coupled with the deregulation of federal thrift powers in the Garn-St Germain Act, have in turn, recently led to far more liberal thrift deregulation in some states. *This wide-open approach to state thrift deregulation has facilitated deep federal subsidies to support a growing array of novel entrepreneurial activities for thrifts that are wholly unrelated to home finance.*

---

ment has a special interest. *Inter alia,* this exists since it insures, through the self-sustaining FDIC and FSLIC, deposits of $100,000 or less of the vast majority of all depository institutions. These deposits are then "intermediated" into those assets, and consequently, these insurance funds stand "at risk" if those assets should "melt" and cause insolvencies (*Confusion in the Legal Framework of the American Financial System and Services Industry, op. cit.,* p. 8).

> But the FSLIC—and the FSLIC alone—bears the responsibility for coping with the infinite variety of new risks created by this state deregulatory trend.[64]

Authority to invest in real estate development is a power long sought by many banks and thrifts. Those states that have granted this authority to their banks and/or thrifts have imposed differing limitations on the investments. In California, where prior to 1984 real estate investment had to be done through a subsidiary, banks can now directly engage in real estate development and management on an entrepreneurial basis. Investments can be made up to 100 percent of bank capital.[65] With this authority, Butterfield Savings Bank of Santa Ana has acquired 10 Wendy's outlets and the 33-restaurant Love's barbecue chain.[66] In Florida, by contrast, state-chartered commercial banks, industrial savings banks and savings and loan associations are allowed to invest up to 20 percent of their assets in subsidiary corporations which can own and lease property. New York State has authorized its state-chartered commercial and savings banks and thrifts to invest up to five percent of their assets in real estate equity, but has also required that up to 10 percent of these real estate investments be made in low-to-moderate income areas.[67]

Some of the nontraditional banking activities authorized for banks by various states include real estate, debt and equity investments, travel agencies, and mutual funds. Conditions and regulations governing these activities vary considerably among the states. Thus, in late 1984, there were 13 states that permitted banks to underwrite or develop real estate, while 5 states allowed banks to underwrite insurance within the bank itself.[68] The result of these changes in state-authorized banking activities is a state-chartered banking system inconsistent with its Federal counterpart.

Interstate banking

States have also taken initiatives in the area of interstate banking. The Bank Holding Company Act provides that the Federal Reserve Board may not approve an application of a bank holding company to acquire or establish banking subsidiaries in other states except where state laws permit entry by out-of-state bank holding companies. The Garn-St Germain Depository Institutions Act of 1982 created a temporary exception which permits interstate acquisitions of failed institutions by out-of-state holding companies.

---

[64] Letter from Edwin J. Gray, Chairman, the Federal Home Loan Bank Board, to Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection and Finance, June 24, 1985, p. 5 (emphasis in original).

Chairman Gray elaborated further:

> *Even though states may empower their state-chartered thrifts to engage in any activity they may see fit, no state treasury is ever called upon to pay even a penny of loss incurred in the failure by an institution which engages in such entrepreneurial activities.*
>
> *Again, when a state-chartered, federally-insured institution fails, it is the federal government which must pay the very heavy costs associated with such failure.*
>
> Those who maintain that any state ought to be able to establish any activity it chooses for its state-chartered thrifts to engage in—any activity whatsoever—irrespective of the federal law to justify the purposes of federally-subsidized credit and federal deposit insurance for thrifts, could better argue the point if: (1) The state supplied the credit; and (2) The full faith and credit of the state, itself, were pledged to underwrite the risk of loss to the state-chartered institution.
>
> Such is not the case. (*Ibid.*, p. 4, emphasis in original).

[65] California Assembly Bill No. 2332, Chapter 360, p. 2.

[66] Allan Stone and Allan Dodds Frank, "An Idea Whose Time Has Gone," *Forbes*, December 31, 1984, p. 89.

[67] Josh Barbanel, "Cuomo Plan Seeks To Spur Investing in Needy Sections," *The New York Times*, September 20, 1984, p. A1.

[68] "FDIC Issues Proposals for New Activities," *American Banker*, Vol. CXLIX, No. 234, November 27, 1984, p. 1.

Most states prohibited or severely limited out-of-state bank holding companies from owning or controlling in-state banks. Recently however, under increasing pressures by out-of-state bank holding companies, a greater number of states have enacted laws permitting out-of-state bank holding companies, under varying conditions, to establish or acquire in-state banks. Some states have reciprocal arrangements whereby banks from another state are permitted to acquire or establish offices in their state in exchange for the same privilege for home-state banks. A more recent phenomenon is the creation of regional reciprocal agreements. A favorable decision by the Supreme Court on the constitutionality of these agreements on June 10, 1985 [69] set off an avalanche of mergers between regional banks. Many observers believe regional interstate banking arrangements are aimed at discouraging national acquisition binges. However, there is also concern that they are being undertaken without sufficient regard for a rising level of concentration in local markets.[70]

Limitations on debt and equity investments

Federal laws place significant restrictions on debt and equity investments by banks and thrifts. As noted, States have liberalized these restrictions with, in some cases, dramatic results. However, there are variations in the way states limit debt and equity investments. California permits its banks and thrifts to invest in the capital stock and obligations of corporations up to 25 percent of their gross capital. No more than 10 percent of their investments can be made in any single corporation, but there is no attempt to limit institutions from gaining control of a corporation. New York does not permit a thrift to acquire more than five percent of any class of an issuer's equity. A New York thrift cannot invest more than 15 percent of its assets in equity securities or more than two percent of its assets in the equity securities of a single issuer.[71]

One of the more unexpected developments in the investment strategies of thrifts has been their purchases, where permitted by state regulators, of "junk bonds"—the name given to the high-yield, non-investment grade securities issued by smaller or less established firms as well as firms whose ratings have been downgraded, and, more recently, by companies, partnerships and individuals engaged in takeover battles and leveraged buyouts. According to some sources, a significant category of investors in Drexel Burnham Lambert's junk financings for takeovers has been a certain number of savings and loan associations.[72] Most of the S&L's involved have been in California, but S&L's in Texas and Florida have also purchased some of this financing. Columbia Savings of Beverly Hills reportedly was part of a group of S&L's that helped finance Saul Steinberg's raid on Walt Disney and Boone Pickens' raid on Phillips Petroleum.[73] This type of investment poses a particular danger to thrifts if individual institutions fail to diversify their portfolios with respect to industry categories as well as individual companies.

---

[69] *Northeast Bancorp v. Board of Governors of the Federal Reserve*, 472 US ——, 105 S. Ct. 2545, 86 L.Ed. 2d 112 (1985).

[70] In a letter to the editor of *The Wall Street Journal* on October 22, 1985, Michelle Meier, Counsel for Government Affairs of the Consumers Union, wrote:

> Unless strict concentration guidelines prevent it, interstate banking is likely to result in fewer banks . . . Competition will decrease and consumers and businesses will have to live with whatever lending policies and depository services the few surviving banks choose to offer.
>
> • • • • •
>
> Also, regional or national banking will be characterized by distant, centralized decision-making.
>
> • • • • •
>
> Since banks are already allowed to set up loan production offices outside their home states, it is obvious that a big motivation behind their current push for interstate banking is to gain access to more deposits.

[71] *Proposed General Regulations of the Banking Board*, State of New York, p. 4.

Regulatory considerations

Not everyone applauds the innovative investments being made by many state banks and thrifts. There has been rising concern both within the banking community and among Federal banking regulators. Joel Wells of Sun Banks in Florida expressed misgivings about the assumption that a free market approach will ensure the safety and soundness of the banking system. He fears that unless the banking industry moves "back to basics", public confidence will be jeopardized.[74]

Others worry about the ramifications of banks and S&L's making high-risk investments with money ultimately backed by Federal insurance programs. These new activities may present an unacceptable degree of risk to Federal deposit insurance. Concern has been expressed by Edwin Gray, Chairman of the Federal Home Loan Bank Board, about several aspects of investments now being made by some thrifts. He is concerned that the rapid growth of assets at hundreds of thrifts is not supported by sufficient net worth.[75] The FHLBB determined:

> Premised in economic theory and borne out by its supervisory experience and the loss experience of the FSLIC, that investments in real estate, stock and other equity investments pose a greater risk of loss to the thrift industry and the FSLIC fund than traditional thrift investments, such as home mortgages.[76]

In response to these perceived risks, the FHLBB has proposed amendments to its insurance regulations including a 10 percent direct-investment limitation without preapproval and the establishment of a "special-purpose" net-worth requirement.[77]

---

[72] John D. Williams, "How 'Junk Financings' Aid Corporate Raiders in Hostile Acquisitions," *The Wall Street Journal*, December 6, 1984, p. 1.

Drexel reports that investors in its offerings include individuals, insurance companies, mutual funds and pension funds as well as savings institutions and other conventional institutional investors.

[73] Sloan and Frank, *op. cit.*, p. 89.

[74] "Sun Bank Pres. Boos Deregulation," *Bank Letter*, a publication of *Institutional Investor*, p. 8.

[75] Leon E. Wynter, and Christian G. Hill, "Bank Board Considers Curbs on Growth of S&L's to Protect Deposit Insurance Fund,'" *The Wall Street Journal*, October 31, 1984, p. 4.

[76] Federal Home Loan Bank Board, *Regulation of Direct Investment by Insured Institutions*, Federal Register 50FR 6912 Feb 19, 1985, p. 3.

However, there is no consensus on the part of the Federal agencies charged with regulation of the nation's banking system, about the ramifications of expanded powers for banks. While Federal Reserve Chairman Paul Volcker has doubts about authorizing real estate development and equity investments for banks, former FDIC Chairman William Isaac and former Comptroller of the Currency C. Todd Conover advocated a far more deregulated environment.[78] On the other hand, the FDIC and the Office of the Comptroller of the Currency (OCC) maintain that mortgages on bank property don't count as capital when figuring a bank's capital on hand, while the Fed would include mortgages when calculating capital.[79] The FDIC has adopted a regulation to allow state non-member banks to establish or acquire subsidiaries to engage in underwriting corporate securities activities at the same time that FHLBB Chairman Gray worries about the rapid growth of S&L's through what he considers to be risky investment strategies. Some of the FHLBB proposals could dampen the enthusiasm of nationally-chartered thrifts to switch to state charters in order to expand their investment possibilities.

Certainly, the financial community is receiving mixed signals as to the direction regulation is going to take for both state- and nationally-chartered institutions. The result is a financial regulatory system that is in disarray. With the absence of a consensus among Federal banking regulators and with some issues pending in the courts, it is increasingly apparent that Congress must review the current status of the dual regulatory system.

Despite these problems, the dual regulatory system has worked effectively in the past. Its defenders have argued that the system has played a useful and constructive role in encouraging innovation and experimentation at the state level, in permitting states the flexibility to accomodate local needs, and in providing "checks and balances" among regulators. In testimony submitted to the Subcommittee, Clarence D. Rappleyea, Minority Leader of the New York State Assembly, argued the merits of the dual regulatory system in providing protection against fraud, anti-competitive behavior and undue concentration of economic power. As Representative Rappleyea effectively illustrates, state regulatory systems also have served as laboratories for regulatory experimentation. States pioneered the establishment of the first permanent bank regulatory agency, the basic system of chartering, periodic examinations of chartered institutions and, most importantly, the providing of insurance to protect the public against the consequences of banks' failures. Even today, many state regulators are at the forefront of regulation of new products and have demonstrated greater flexibility and responsiveness than Federal regulators.[80]

---

[77] *Ibid.*, pp. 22-24.

[78] Monica Langley, "Rival Bank Regulators Agree Only to Disagree on Most Major Issues," *The Wall Street Journal*, January 23, 1985.

[79] *Ibid.*, p. 26.

[80] Statement of Clarence D. Rappleyea, Minority Leader, New York State Assembly, *Financial Deregulation in New York State*, *op. cit.*, pp 118-126

Nevertheless, many now believe some states have not acted responsibly in expanding the powers of financial institutions, and have not committed sufficient resources to regulatory authorities to assure soundness. The current climate is one that could easily precipitate a regulatory "race to the bottom." If Congress fails to confront real regulatory disparities and to establish boundaries within which the dual system can continue to function constructively, states may play a disproportionate role in the future, possibly preempting Federal regulators. On the other hand, change merely for the sake of minimizing regulatory disparities and increasing competitive opportunities could undermine the equally important objectives traditionally met by the regulation of financial institutions.

SUMMARY AND POLICY CONCERNS

As this discussion of recent developments affecting various types of customer protection suggests, regulatory strategies designed to protect customers of financial institutions are less effective now than in the past. Several proposals have been made to address this problem, including proposals to consolidate related financial services offered by a given institution in a separate subsidiary subject to the jurisdiction of the appropriate regulator, functional regulation of products or activities by the appropriate regulator regardless of which institution is offering the service, and changes in deposit insurance programs or coverage. There appears to be little outright hostility to the conceptual outlines of most of these proposals, but there is some skepticism that any one (or all) of them will resolve the problems raised by the system's current level of fragility, or by the overlapping of products and functions, or erosions in regulatory standards for soundness and fiduciary responsibility.

Meanwhile, and as a counterpoint to debate on these issues, the focus on competitive inequities—frequently attributable to the same developments that have undermined customer protection—has also prompted a number of proposals. Some—particularly those related to functional regulation—are similar to those that would address concerns about customer protection. Those that specifically address the issue of competitive inequities include proposals to consolidate regulation by reducing the number of regulators, or to simplify regulatory strategies to reduce conflicts that arise as a result of the regulation of similar functions and products by different agencies.

For many, resolving the problem of competitive inequities is all that is required. Their proposals have received the lion's share of attention. Aside from proposals to strengthen the deposit insurance funds and state insurance guaranty programs, the issue of customer protection and strategies to cope with developments that have made protection less effective have been little discussed. A thorough exploration of the concept of functional regulation—widely viewed as the best means for dealing with disparities in competitive opportunities as well as differences in fiduciary standards—has not taken place. For example, it is not clear whether proponents of functional regulation intend that CMAs and banks' "sweep accounts" be regulated by the same agency. If so, will it be the SEC or a bank regulator? If not, will disparities in customer protection and/or competitive opportunities persist? And can regulators that focus on the individual functions of a consolidated financial holding company adequately police the intra-company transactions between subsidiaries to prevent conflicts of interest and self-dealing that undermine both competition and customer protection?

Because technological innovations have introduced changes in functions and products of financial institutions that have clearly changed the effectiveness and applicability of the existing regulatory framework, a new framework will be required to reinstate both competitive equity and customer protection. For example, a spokesman for one of the self-regulatory organizations (SROs) has noted that:

> Securities regulation, which has experienced significant advances in the last decade as a result of technological improvements, is presently being confronted with significant obstacles to its effectiveness in a rapidly expanding marketplace whose own growth has been stimulated by technology . . .
>
> These developments, by increasing the speed, dispersion and complexity of the marketplace, have introduced new challenges for the regulator, particularly with respect to market surveillance and enforcement. Although technology will continue to assist in confronting many of these challenges, others, particularly those involving varying governmental and jurisdictional constraints, are more difficult to overcome and call for compensating adjustments to our existing regulatory framework.[81]

But revisions of the regulatory framework that merely shift responsibilities from one regulator to another may not accomplish the objective of revitalization. The content as well as the form of regulation may need attention. The failure to examine the applicability of existing regulatory strategies and devise new strategies to replace those that no longer achieve the goal of protecting customers could lead to a further weakening of fiduciary standards necessary to maintain the soundness of the financial system and the confidence of its customers.

---

[81] Richard O. Scribner, Executive Vice President, American Stock Exchange, "The Technological Revolution in Securities Trading: Can Regulation Keep Up?", *Technology and the Regulation of Financial Markets*, Edited by Lloyd White and Anthony Saunders, Lexington Books, D.C. Heath & Co., 1986, pp. 1-2 of unpublished manuscript on file with the Subcommittee.

CHAPTER 2: INVESTOR PROTECTION

INTRODUCTION: THE ROLE OF DISCLOSURE

Disclosure is the cornerstone of the regulatory scheme that governs securities markets. Information disclosure requirements are intended to ensure that investors can make informed decisions about investing in financial assets sold in public markets. The basic philosophy underlying securities laws is that full disclosure, even of adverse information, will promote public confidence in the capital markets and thus encourage investments that finance economic growth.

The Securities Act of 1933 was not only the first Federal securities law, but also incorporated disclosure for the first time as a major element in the regulatory scheme.[1] The Act was designed to achieve "truth in securities" in connection with public offerings. The following year, Congress passed the Securities Exchange Act of 1934—its primary purpose being regulation of securities brokers and dealers and the markets in which they operate—which also requires extensive disclosure regarding securities traded in certain of those markets. The 1933 Act is potentially applicable to any company, but only on the occasion of a public offering. The 1934 Act is applicable to a particular group of issuers who have securities listed or traded on an exchange, or who are presumed to be the subject of active investor interest in the over-the-counter market by reason of having as many as 500 holders of a class of equity securities and at least $1 million in assets. While the 1933 and 1934 Acts exempt Federal and state and local government securities from registration and disclosure requirements, and the 1933 Act exempts securities issued by depository institutions, no securities are exempt from the fraud provisions of the securities acts.

Disclosure requirements in connection with new issues of financial instruments depends upon whether the instrument is subject to the disclosure requirements of the Securities Act of 1933. Under the Securities Act of 1933, most companies are required to file a detailed registration statement with the Commission when making a new offer. The statement contains a prospectus, a copy of which is furnished to every purchaser, and additional information which is available for public inspection at the Commission. A further disclosure duty requires that issuers not make any materially false or misleading statements or omit any material information in statements issued in connection with the offering. Therefore, the 1933 Act required disclosure of unfavorable, as well as favorable facts. In addition, the Securities Act imposes civil liabilities on corporate directors, underwriters and experts for misstatements in a registration statement, thereby encouraging close scrutiny of registration statements by those groups.

---

[1] For a discussion of historical developments leading up to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, see Part I, Chapter 2.

The Securities Exchange Act of 1934 requires disclosure by issuers whose stocks are traded on the exchanges or in the over-the-counter markets and which meet the threshold levels in terms of the number of shareholders and assets. These issuers are required to file registration statements, periodic reports and proxy materials. Anti-fraud provisions impose additional disclosure obligations under some circumstances. In 1982, the Commission took a major step toward integration of the 1933 and 1934 Acts' disclosure requirements with the adoption of an "integrated disclosure system".

Like most regulatory tools, current disclosure requirements are the result both of the initial legislative framework and an evolutionary process. Proposals to increase the amount of disclosure required by depository institutions reflect the continued viability of this mechanism as a regulatory tool whose goal is to assure public confidence in securities markets. The recent extension of disclosure requirements to mortgage-related securities issued by non-government entities is also evidence of its viability and of continued Congressional commitment to investor protection.[2]

Nevertheless, disclosure requirements are likely to undergo additional changes regardless of how financial restructuring proceeds. Even without a further expansion of bank powers, changes in the disclosure of information regarding nonbanking financial institutions will be required to take into account the consolidation of financial functions outside the banking system—the mergers of securities and insurance companies, for example, or the acquisition by these intermediaries of mortgage banking, commodities, and other financial affiliates, or their links with nonfinancial companies. And the consolidation of financial functions will require greater disclosure of information about transactions between affiliated entities within a financial conglomerate so that investors can ascertain how the fortunes of one affiliate may affect the performance of others and of the company as a whole. So far, the debate on extending disclosure requirements in response to financial restructuring has focused primarily on its impact on depository institutions. The major issues involved in that debate are outlined below.

But there are other important pressures affecting disclosure with which the SEC and Congress are also concerned. The growing internationalization of the capital markets and disparities in the regulatory schemes governing the major national markets involved in the movement toward integration will require harmonization of regulatory mechanisms to prevent erosion of the effectiveness of disclosure and other U.S. strategies to protect investors. Without that effort, there will be an inevitable erosion of U.S. standards.

While there are other investor protection issues which may be equally important, the limited scope of this report necessarily dictates a high degree of selectivity. Therefore, the remainder of this section focuses on the two major issues that have already been identified as involving a relationship between investor protection and financial restructuring: the role of disclosure in regulating depository institutions and the impact of internationalization on the regulatory framework for U.S. securities markets.

---

[2] P.L. 98-440, The Secondary Mortgage Market Enhancement Act. The House Report on this legislation (H.Rep.98-994, September 6, 1984) offers a more extensive discussion of current Congressional attitudes toward disclosure.

DISCLOSURE REQUIREMENTS FOR DEPOSITORY INSTITUTIONS

The roles disclosure plays in the regulatory scheme that governs securities markets and depository institutions are very different. It was believed that government supervision and soundness regulation rather than disclosure of risk would prove to be a better scheme for protecting depositors. Moreover, it was feared that disclosure of financial difficulties by depository institutions might cause runs on banks and failures of institutions that otherwise would survive.

Nevertheless, pressures have increased to expand the role of disclosure in the regulation of depository institutions. The increase in the number of bank and thrift failures in recent years has raised concern that perhaps shareholders of depository institutions do not have adequate information to make reasonable investment decisions and to compare investment in depository institutions with investment in other financial institutions and nonfinancial public companies. Regulators of these institutions also have proposed a greater degree of disclosure to depositors as well, to bring more market discipline to depository institutions' operations. Many believe increased disclosure is necessary because of increased interdependence in the marketplace and the wider array of products offered by depository institutions.

Currently, banking and thrift institutions are given special treatment under most provisions of the securities laws regulating both the issuance and distribution of securities in the United States. Section 3(a)(2) of the 1933 Act exempts national and state banks from the provisions regarding registration of new issues and delivery of prospectuses, but not from the antifraud provision. Although Congressional intent is not clearly stated, the legislative history of the Act implies that Congress believed that the depository institutions' regulators would fulfill a comparable role through supervision.

Congress did not exempt banks from the registration reporting requirements of the original Securities Exchange Act of 1934. The SEC granted a temporary exemption from registration to bank securities listed on the exchange which was never rescinded. Moreover, bank securities traded in the over-the-counter market were not covered by the Act until 1964 because the Act applied only to securities listed on a national exchange. Consequently, from 1934 to 1964, banks were not subject to the coverage of the Securities Exchange Act of 1934.

The passage of the Securities Act Amendments of 1964 extended the disclosure provisions of the 1934 Act to securities traded in the over-the-counter market, including those of approximately 1,000 banks which met the threshold levels of assets and shareholders. However, the 1964 amendment removed administration of the reporting and disclosure requirements from the jurisdiction of the SEC and placed it with the bank regulatory agencies. Nevertheless, antifraud and other provisions of the Act have continued to be enforced by the SEC.

In 1974, legislation was enacted which directed the appropriate depository institution's regulatory agency to issue regulations "substantially similar" to those of the SEC, within 60 days of adoption of SEC rules, unless public interest concerns require otherwise. Consequently, the Federal Reserve, Comptroller, FDIC and FHLBB administer the periodic reporting and other provisions of the Act as applied to both depository institutions with listed securities and those with securities traded on the over-the-counter market.

The exemptions given to depository institutions do not extend to their holding companies. Although financial institution holding companies were not a widely-used organizational form until the late 1920s, a significant number of multibank holding companies appeared later and, in 1940, were brought under coverage of the securities laws. With passage of the Bank Holding Company Act Amendments of 1970 that extended holding company regulation to companies that held only one bank, most of the major money center banks and a substantial number of regional banks became subject to a greater degree of disclosure by virtue of the fact that their holding companies were subject to the registration and reporting requirements of the 1933 and 1934 Acts.

Nevertheless, what little information the holding company disclosed about its bank affiliate—most often the dominant entity within the company—was based on standards determined by bank regulators. And if the bank issues stock directly to the public, SEC registration is not required. Even though the SEC has actively pressed for a greater degree of disclosure about the financial condition of bank affiliates of holding companies in recent years (and has continued to encounter opposition from some bank regulators),[3] a number of important disparities in disclosure requirements remain.

At a 1983 Subcommittee hearing, John S.R. Shad, Chairman of the Securities and Exchange Commission, summarized the principal differences between the SEC approach with respect to the issuance of securities by bank holding companies and the bank regulators' approach with respect to the issuance of securities by banks. The guidelines of the bank regulators regarding disclosures about banks' financial condition, profitability, foreign and domestic lending activities and loan loss experience are not as detailed as those of the SEC. The SEC and the FHLBB require financial statements audited by independent accountants. The Comptroller requires audited statements only in limited circumstances and the FDIC does not require them at all. In addition, the Securities Act of 1933 provides a structure for admission remedies and defenses which is not provided in the regulatory structure provided for banks.[4]

Chairman Shad observed that, notwithstanding the 1974 amendments, the resulting system is a fragmented one, with dissimilar disclosure requirements for banks, thrifts, and other companies. As discussed, the Federal Reserve Board, the Comptroller and the FDIC—unlike the SEC and the FHLBB—do not require that financial statements be certified by independent auditors. Instead, they accept financial statements that are verified by a bank financial officer or internal auditor The SEC has established a guide for statistical disclosure by bank holding companies (and is considering a similar proposal for savings and loan holding companies.) This disclosure guide provides for analytical disclosure about a bank's financial condition, profitability, foreign and domestic lending activities and loan loss experience.

---

[3] See, for example, Andrew Albert, "SEC: Tough New Regulator for Banking". *American Banker*, November 28, 1984, pp. 1,8,9,10.

[4] Statement of John S.R. Shad, Chairman, Securities and Exchange Commission, *FDIC Securities Proposal and Related Issues*. Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, June 16, 1983, Serial No. 98-46, p. 27.

In addition, different standards are employed in preparing financial statements. The SEC requires that annual financial statements be prepared in accordance with generally accepted accounting principles ("GAAP"). Banks, however, prepare their financial statements in accordance with GAAP modified for certain Regulatory Accounting Principles ("RAP") which may differ depending on the bank regulator.[5] The SEC has retained authority to regulate the issuances of securities of bank holding companies, state-chartered, non-insured banks and other banks that are not subject to regulation by the Comptroller, the Federal Reserve Board or the FDIC. The SEC administers disclosure requirements for over 825 bank and thrift holding companies, which own and operate the nation's 100 largest banks and six of the ten largest thrifts.[6] Bank holding companies whose securities are registered under the 1934 Act are subject to the continuous reporting requirements and proxy solicitation regulation of the Act. The SEC requires substantial disclosure by these holding companies of lines of business, nonperforming loans, loans to "insiders" and other similar matters. More recently, the SEC has required greater detail regarding disclosure by holding companies of large loans to foreign countries.

Even in areas where the disclosure requirements promulgated by the various regulatory agencies appear similar in fundamental respects to the disclosure requirements that apply to business enterprises subject to SEC requirements, the traditional regulatory attitudes of the administering agencies toward disclosure may nevertheless be very different. The objective of the bank regulatory agencies has been to preserve the soundness of individual institutions and the integrity of the banking system as a whole. This objective influences their approach in requiring compliance with disclosure requirements. Generally, the agencies prefer to allow institutions time to resolve financial difficulties. This approach clearly is antithetical to the theory of a marketplace governed by the intense glare of full disclosure.

In the past, regulators of depository institutions have tended to minimize disclosure in cases where it might exacerbate the problems of troubled institutions. This tendency toward secrecy has been widely criticized. Recently, however, bank regulators have taken steps towards increased reliance on disclosure. For example, as a result of a coordinated effort, the regulators adopted a new system to collect information on domestic and foreign nonperforming loans for inclusion in Call Reports beginning in June, 1983, and subsequently promulgated rules for disclosure of regulatory enforcement actions. Still, many believe that these steps do not go far enough and have called for the inclusion of depository institutions within the comprehensive disclosure program administered by the SEC.

---

[5] *Ibid.*, p. 28.
Thrifts also use "RAP". It is widely acknowledged that if they used "GAAP", many thrifts would appear insolvent.
[6] *Ibid.*, p. 26.

Proposals for greater disclosure by depository institutions

Increased disclosure for shareholders. SEC Chairman Shad has recommended that exemptions from the securities laws for banks be eliminated and that responsibility for the registration of securities issued by banks and thrifts and disclosure by these institutions be consolidated within the SEC.[7] In testimony before the Subcommittee, Chairman Shad explained why he believes such consolidation is necessary:

> Effective disclosure inspires investor confidence. Uniform standards, consistently administered, facilitate comparative analysis by securities analysts and investors of the risks and rewards of investments in banks and thrifts, as compared with financial, securities, investment, mortgage, and other companies.[8]

Chairman Shad's proposal appears to be grounded in the belief that bank regulators have not effectively devised and administered comparable disclosure requirements and that shareholders of depository institutions are entitled to as much information as shareholders of other business enterprises. The Chairman argues that differences in disclosure requirements in offering circulars, prospectuses and periodic reports create a lack of comparability between banks, thrifts, securities and other financial firms from the point of view of an investor attempting to decide where to invest his funds. This results because financial statements provide differing views of the financial condition of an enterprise, depending upon whether GAAP or RAP principles are used, as well as which agency is interpreting the rules. Financial statements of depository institutions also lack the additional assurance provided by an independent audit.

Leaving aside the issue of whether the consequences of additional disclosure can be reconciled with the aim of maintaining the integrity and soundness of the banking system, the context within which depository institutions face disclosure is different in many important respects from most other companies. It remains unclear whether full disclosure of all "material" facts by depository institutions will really lead to comparability on a fair and equal basis.

For example, the regulatory process that generates examination reports and detailed enforcement agreements covering business matters of depository institutions does not exist for most companies. The typical company does not have a government agency deciding that it must change management or disclose that it must raise a specified amount of capital by a certain date. *Securities and*

---

[7] *Ibid.*, p. 30.

[8] *Ibid.*, p. 30.

Exchange Commission v. *Youmans, et al.*[9] held that, with respect to bank holding companies, restrictions imposed under an agreement with the Comptroller of the Currency should be disclosed as material facts. Comments by regulators and any required changes in certain conditions may become "material" if banks are required to comply with disclosure requirements administered by the SEC. Financial analysts may reach similar conclusions about the financial conditions of industrial companies and disseminate the information. Nevertheless, the company is not required to publicize these views itself. Depository institutions would be required to formally disclose any adverse views handed down by their regulators—views which carry the imprimatur of the government.

Such disclosures may raise concerns regarding confidence. Disclosure of adverse regulatory action may create a run on a bank that is otherwise sound. Moreover, there is no question that regulators can be wrong. Consequently, the importance of maintaining confidence in depository institutions and the banking system still may set these enterprises apart from others and preclude greater disclosure.

Increased disclosure for depositors.—Disagreeing with arguments that increased disclosure will undermine the soundness of the banking system, William M. Isaac, former Chairman of the Federal Deposit Insurance Corp., and FDIC staff have argued that greater disclosure in fact would create a healthier banking system.[10] The FDIC has expressed concern that the current bank regulatory system incorporating deposit insurance, secrecy and extensive government regulation encourages excessive risk-taking because institutions are not permitted to fail and depositors do not have to inform themselves of the bank's financial condition.

Theoretically, Federal deposit insurance covers accounts only up to $100,000. In reality, the Federal safety net often covers even those depositors with over $100,000 because, as discussed in the following chapter, the regulators will merge a failing institution with a healthy one to protect the community or minimize outlays of insurance reserves. Under the current system, the large depositor often elects to support higher risk banks where he enjoys the higher yield the bank must offer to attract deposits.[11] Such a depositor takes the view that he need not worry about risk since the costs associated with the failure of an institution will be borne by the Federal deposit insurance fund.

In response to these and other developments, the FDIC has proposed the adoption of a tiered system of deposit insurance accompanied by greater disclosure to make banks more sensitive to market forces. Under such a system, depositors with deposits of over $100,000 would share the losses with the government, while small depositors would continue to be totally insured.[12] Since large depositors also would receive more information, they could better judge the risk of placing their funds in a particular bank. According to the FDIC, the overall result would be a sounder banking system because well run banks would have access to funds at a lower rate than poorly run banks.

---

[9] Civil Action No. CIV-1-79-216, E.D. Tenn., 1982.

[10] *Deposit Insurance in a Changing Environment.* A report to Congress on Federal Deposit Insurance prepared by the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board and National Credit Union Administration for the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, June 1983, Ch. IV, p. 89, S. Prt. 98-65.

[11] See the section dealing with brokered deposits in Part II, Chapter 1, and the section on proposals to reduce insurance coverage in Part III, Chapter 3 for a discussion of a related study done by the Federal Reserve Bank of New York.

It could be argued that since higher yields are offered to offset risk, insured banks should have no need to offer higher yields to attract funds—the risk is covered by insurance. Nevertheless, many failures of depository institutions have been associated with a rapid increase in assets as well as more risky assets, and funding that growth has required that these institutions compete for a limited supply of funds by offering higher yields on deposits.

The tiered insurance system depends upon a much greater role for disclosure. Chairman Isaac believes that greater disclosure can substitute for increased government intervention. The FDIC is concerned about the rising risks in the banking system and increased demands on the Federal deposit insurance program. In spite of the current high level of risk to the insurance fund posed by the fragility of a significant number of banks,[13] Mr. Isaac nevertheless favors authorizing banks to engage in activities that carry additional risk because these activities currently appear to be more profitable than banking. Profits are essential to maintaining a strong, stable banking system, he has argued, and the volatility of bank profits in the wake of interest rate deregulation indicates the need for new sources of income.[14]

Concerns about extending disclosure to depository institutions

Given the increased blurring of distinctions between financial instruments, is it appropriate to review the role of disclosure requirements within the regulatory schemes applied to financial institutions? In addition to providing investors with information for comparative analysis of various investments, can disclosure also serve as an effective regulatory deterrent to excessive risk-taking by financial institutions? Can market discipline effectively replace risk management schemes involving direct supervision and regulation by bank regulators?

The proposals by the SEC and the FDIC are based on a number of assumptions. For example, they assume that depositors as well as investors are willing and able to interpret bank financial information—or should be required to do so in the future—to protect their deposits. Depositors currently lack both an awareness of what bank data are available and the ability to use and understand the data that are disclosed. The FDIC study admits that advanced techniques of financial analysis are largely unknown to all but the most sophisticated of bank customers, and that it is unlikely that the public will use information that it does not know how to analyze. Their surveys show that the general public—and even treasurers of small corporations—have little understanding of basic bank financial information. They further point out that "it is only the truly sophisticated data users, including institutional investors, investment banking firms, rating firms, large money funds, large banks, and large corporations, that possess the proper analytical skills for evaluating risk in banks." [15]

---

[12] For example, all depositors might be insured for the initial $100,000, but only up to 80 percent of their second $100,000, up to 60 percent of the third $100,000 and so on.

[13] The risk to the FDIC currently is at the highest level since the 1930s. Seventy-nine banks failed in 1984 and 120 in 1985, up from 48 in 1983 and compared with an average of 10 per year in the period 1975-1981 and 4.2 per year in the preceding two decades. (*Deposit Insurance in a Changing Environment*, *op. cit.*, p. 113.)

[14] *FDIC Securities Proposal and Related Issues*, *op. cit.*, p. 169.

One explanation for the public's disinterest in bank financial data that is often cited is the belief that bank regulators will handle the failure of a bank in a way that will protect all bank depositors. If these methods fail, Federal insurance will cover deposits up to $100,000. Nevertheless, the FDIC argues that this attitude on the part of depositors will change if they are forced to take on more risk as banks expand their activities and that the perception that the government will protect all parties will fade. As a result, bank customers will become accustomed to considering risk in addition to other factors when choosing a bank.

The argument is made that the situation can be alleviated by customer education and by transforming financial information into less technical, more comprehensive and informative forms of disclosure. It is not clear how customers will be educated other than by means of self-education. Nor have specific recommendations been made with respect to how banks might simplify their disclosures so that they are more understandable to the public. The FDIC study suggests that expanded use of rating services that translate bank financial data into more simplified forms may provide better public understanding of the financial condition of banks.

Are these rating services an adequate substitute for analysis and supervision by Federal regulatory agencies? Given the occasional failures of rating agencies to accurately rate securities issues, is this a realistic approach? Problems with bonds issued by New York City and the Washington Public Power Supply System (WPPSS) were not detected by the rating agencies. Will they do better when confronted with the task of rating thousands of banks? Currently, the rating agencies do not cover the vast number of smaller banking institutions. How might this information gap be filled? Under a regulatory system based on disclosure, shouldn't every depositor, as well as equity investor, have access to information on the depository institution's financial condition?

More fundamentally, do depositors view their bank deposits as comparable to other investment instruments? Those who advocate more reliance on market discipline in managing risk assume that if investors in securities are expected to inform themselves of the risk associated with their investment, depositors should also be expected to inform themselves with respect to the financial condition of their bank. It is not clear that this assumption is supported by the perception held by the public of the role banks play in the financial system.

The differences discussed above in disclosure and other regulations reflect the different regulatory mandates given to the SEC and the bank regulatory agencies. Soundness regulation generally has been thought to be inconsistent with full public disclosure. Banking law and regulation since the 1930s has reflected a fear that disclosure by banks of their financial condition will jeopardize the safety and soundness of individual banks and lead to instability and volatility in the banking system. The bank regulatory system is based upon the belief that public knowledge or misinterpretation of information regarding a bank's condition can cause overreaction and runs on a bank. News of initial depositor withdrawals may lead to a string of withdrawals by other depositors and eventually may cause a bank to fail. This scenario was played out in the 1930s and contributed to the failure of thousands of banks.

---

[15] *Deposit Insurance in a Changing Environment, op. cit.*, p. 94

In 1933, Representative Steagall, one of the primary sponsors of the Banking Act then under consideration, explained its purpose and enunciated the Congress' intent with respect to the goal of banking regulation:

> The purpose of this legislation is to protect the people of the United States in the right to have banks in which their deposits will be safe. They have a right to expect of Congress the establishment and maintenance of a system of banks in the United States where citizens may place their hard earnings with reasonable expectation of being able to get them out again on demand.[16]

As this statement indicates, the concerns of Congress in creating the bank regulatory scheme were quite broad: to prevent threats to the stability or security of the banking system. Public confidence in banks and the banking system as a whole was seen as an important element in stabilizing the economy. Banks were viewed as being different from other financial institutions because of their crucial role in the payments system and in providing liquidity to maintain stability in the economy.

Although both securities and banking regulatory schemes were designed to protect investors, they sought to achieve this end in very different, perhaps even totally contrary, ways. As former SEC Commissioner James C. Treadway commented:

> Logic suggests that the two schemes are flatly antithetical. The harsh spotlight of full disclosure creates a healthy skepticism and is prepared to sacrifice if necessary the enterprise to encourage public confidence. Safety and soundness regulation seeks to preserve the enterprise and assure the absolute safety of investment. That eliminates any need for skepticism.[17]

Mr. Treadway argues further that the debate regarding a "level playing field" has not fully taken into account the tension and conflict that exist between a regulatory scheme adopted for banks having "protect-the-enterprise-and-system" objectives, and a regulatory scheme for other securities issuers having a "protect-the-investor, even at the expense of the enterprise" objective.[18]

---

[16] Floor debate, U.S. House of Representatives, *Cong. Rec.*, Vol. 77, Part 4, 73rd Cong., 1st Sess., May 20, 1933, p. 3837.

[17] James C. Treadway, Jr., Commissioner, Securities and Exchange Commission, "A Seamless Web: Banks, New Activities and Disclosure", Keynote speech to the Third Annual Seminar on Securities Activities of Banks, New York, N.Y., September 29, 1983, pp. 5-6.

[18] *Ibid.*, p. 3.

Although the emphasis here is on disclosure, other aspects of securities regulation (including the role of the self-regulatory organizations) are designed to ensure orderly markets and thus to provide protection for broker-dealers and underwriters as well as issuers and investors.

Yet, if the scope of bank activities is to be expanded to include activities involving new risks for banks, greater disclosure or greater government regulation may be required. Market discipline could have a significant effect on the banking system. If the discussion of market discipline is serious, it would mean full disclosure of all material information, both positive and negative. More important, banks must be allowed to fail, and shareholders and large depositors must be permitted to suffer losses for market discipline to be effective.

Former SEC Commissioner Longstreth in testimony before the Subcommittee suggested that the cost of a rising level of bank failures may be unacceptable. This is so because the linkages among financial institutions have become too extensive to prevent one failure from triggering others. The collateral consequences of failures could pose unacceptable costs to the system.

For most of the past fifty years, the American public has been accustomed to a system where banks generally do not fail, and where the effects of failure are carefully mitigated by government regulators.[19] Whether or not the public is ready and willing to permit market discipline to rule is unclear. But it is a question that should be fully explored in the context of proposals for increased disclosure.

THE IMPLICATIONS OF THE INTERNATIONALIZATION OF CAPITAL MARKETS FOR INVESTOR PROTECTION

Technological advances in telecommunications and data systems have increased the mobility of capital and dramatically increased the internationalization of capital markets. Increased internationalization of capital markets has major implications for the way companies raise capital and investors choose among investment opportunities. It also significantly affects the ability of regulators to enforce their country's regulations and laws.

Many companies' securities are now traded on a global basis around the clock. As flows of international trade have increased, most industrialized countries have become more dependent upon international finance. The growth of multinational corporations has further encouraged the trend. But the internationalization of capital markets is relatively recent. As recently as a decade ago, less than one-third of the free world's total equity capital was invested outside the United States; today, over one half of the total is invested abroad. While U.S. markets stagnated for several years in the 1970s and 1980s, foreign capital markets expanded. During the last decade, Japanese market capitalization climbed nearly tenfold; Singapore's increased 16 times; Hong Kong 20 times; and even Germany's market more than doubled in size. The Eurobond market has also grown dramatically with total new issues of approximately $190 billion in 1984 and significant increases in the volume of funds raised by U.S. issuers.

Although part of the tremendous growth in foreign markets is due to very low starting points abroad, some experts believe that these figures indicate a long-term trend despite the recent international attraction to high U.S. interest rates and a strong dollar. Already, the sheer diversity of investment opportunities offered worldwide can be overwhelming. An investor can choose among more than 7,000 companies spread across 16 markets, and there are approximately 236 "world class" issuers whose securities are regularly traded in international markets.[20]

---

[19] *FDIC Securities Proposal and Related Issues, op. cit.*, p. 80.

The internationalization of capital markets has already had a dramatic impact on U.S. domestic issuers and investors. From 1971 to 1981, transactions by foreign financial institutions in the U.S. securities markets increased more than six-fold, from $31 billion to $198 billion.[21] Total foreign investment in U.S. corporate stocks and bonds rose from $25.6 billion in 1970 to $74 billion in 1980. During this same period, American investment in foreign stocks increased from $6.4 billion to $18.9 billion, and U.S. investment in foreign bonds rose from $13.2 billion to $43.2 billion. At year end 1983, foreigners held $114.6 billion of U.S. corporate securities and U.S. residents held $84.8 billion of foreign securities.[22]

The next step, the integration of markets, was made possible, in part, by the relaxation of currency and investment restrictions and advances in global communications. Japan, Canada and Australia have relaxed rules on foreign investment, and major changes have been adopted by the London Stock Exchange: ending fixed commissions in 1986, authorizing stockbrokers to hold shares for themselves as well as trade for others, and allowing foreign firms a greater role in trading. The Boston and Montreal stock exchanges are now linked and the Chicago Mercantile Exchange has established a link with the Singapore International Monetary Exchange. The American Stock Exchange is setting up linkages with Toronto and Amsterdam, an exchange of quotations between NASDAQ and London is being inaugerated and additional linkages between New York and London stock and commodity exchanges are also planned.

Many benefits have resulted from the free flow of capital. Corporations have been able to broaden their ownership base and enjoy a wider market for their securities. They also can more easily fill their needs for foreign exchange to run their global operations by issuing securities in several currencies. Investors benefit from more investment opportunities and can spread risk among a wider number of economies, currencies, industry sectors and companies. Finally, many argue that the international flow of capital increases overall welfare by encouraging the most efficient allocation of world financial resources.

---

[20] John S.R. Shad, Chairman, Securities and Exchange Commission, "The Expanding Securities Markets: Regulatory and Economic Issues", *Financial Restructuring*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong., 1st Sess., Serial No. 99-21, May 2, 1985, p. 203.

[21] Bevis Longstreth, Commissioner, Securities and Exchange Commission, "Toward Neutral Principles of International Securities Regulation", Remarks to the Seminar on the European Business World and the Extraterritorial Application of United States Economic Regulation, Zurich, Switzerland, September 24, 1982.

[22] U.S. Department of Commerce, "U.S. International Investment Position", *Survey of Current Business*, various issues.

See Part I, Chapter 3 for a discussion of the internationalization of markets for other financial assets.

The internationalization of capital markets also raises a number of concerns. Some observers believe that if nations ignore the international component of securities markets, the process could result in diminished investor protection, economic misallocations and excessive volatility in the marketplace. Growing interdependence increases the sensitivity of the financial system to changes in international political and economic conditions. Internationalization increases the likelihood of a major shock to national and international financial systems while decreasing the ability of financial institutions to cope with shocks. Competitive pressures may encourage financial institutions to commit more funds in foreign currency and money markets, creating greater instability. Regulatory surveillance is too fragmentary to respond effectively to international crises or fragility in the system. As both domestic and international markets reach "beyond the jurisdictional boundaries within which the self-regulators[23] and national regulatory authorities have historically worked",

> No single SRO has sufficient surveillance information or broad enough disciplinary jurisdiction fully to regulate conduct affecting its market. Nor does the SEC have the information or jurisdiction to reach conduct occurring beyond our national borders that has consequences in the U.S. securities markets. Moreover, the technology revolution. . . . is likely to heighten those limitations.[24]

Enforcement problems

The growing presence of foreign participants in U.S. capital markets has complicated enforcement of U.S. laws designed to protect investors and maintain confidence in the markets. As participation by foreign brokers, dealers, purchasers, sellers and others increases, foreign actors become more influential players in, and have greater impact on the integrity of U.S. capital markets.

In recent investigations, SEC officials increasingly have encountered foreign parties who have concealed their interest in U.S. securities. On occasion, American and foreign investors use foreign financial institutions to effect securities transactions in the U.S. markets in order to benefit from foreign secrecy laws or blocking statutes. Secrecy laws protect the identity of customers who make use of the services of the country's financial institutions. Blocking statutes impede judicial or administrative proceedings by restricting testimony or the production of documents.[25] Twenty-six countries have bank or other secrecy laws which cover securities transactions and over twenty other countries have blocking statutes.

---

[23] In the United States, self-regulatory organizations (SROs) include the various stock exchanges, the National Association of Securities Dealers (NASD) for the over-the-counter market, and various rulemaking boards.

[24] Richard O. Scribner, Executive Vice President, American Stock Exchange, "The Technological Revolution in Securities Trading: Can Regulation Keep Up?", *Technology and the Regulation of Financial Markets*, Edited by Lloyd White and Anthony Saunders, Lexington Books, D.C. Heath & Co., 1986, p. 11 of unpublished manuscript on file with the Subcommittee.

Mr. Scribner suggests that the problem may "become even more acute" if unregulated markets spring up offshore. He notes that "the technology to do so is readily available, and the International Futures Exchange or 'Index', located in Bermuda, is even now seeking to establish a worldwide electronic futures trading mechanism" (*Ibid.*, p. 16).

[25] These laws prohibit the disclosure, copying, inspection or removal of documents located within the country which has the statute. Some statutes apply to all documents, others apply to limited categories

Typically, upon obtaining information indicating that conduct violating the securities laws has occurred, the SEC seeks trading data regarding the transactions by a firm and its customers during a specified time period, including identification of account numbers and account holders. Blocking statutes and secrecy laws inhibit SEC investigations in areas where the identity of participants and their holdings are crucial to the success of the investigation. This information is important in cases involving violations of prohibitions against insider trading, of requirements regarding tender offers, of requirements for disclosure of acquisitions of more than five percent of a class of securities registered with the Commission, of registration requirements for new issues and in cases involving market manipulation and laundering of funds generated by illegal activities.

Concerns have been raised by the Commission and others that the inability to enforce U.S. securities laws prohibiting fraud and other illegal conduct as they relate to foreign participants in the United States market tends to undermine investor confidence in the integrity of our marketplace. Close surveillance and a commitment to strong enforcement of the securities laws contribute to ensuring the honesty and fairness of market activity and encourage investor participation. The inability to enforce securities laws where foreigners are concerned could create a double standard that may undermine the effectiveness of the statutory scheme designed to protect investors and stabilize the U.S. capital markets. To meet these concerns, the Commission has attempted to negotiate bilateral agreements with other nations to improve cooperation in the area of law enforcement and formulate solutions to problems resulting from regulatory disparities between the U.S. and foreign markets.

Proposals for harmonizing regulatory systems

Although the internationalization of securities markets has increased tremendously in recent years, the percentage of total market activity represented by international transactions is still small. Barriers to foreign participation both by broker-dealers and issuing companies still are pervasive in markets throughout the world. Companies may be subject to inconsistent, duplicative and even conflicting regulations. Companies that issue securities in more than one country may be required to disclose substantially identical information in differing formats.

Although the London Stock Exchange is lifting its long-standing restrictions on foreign broker-dealers, other foreign markets, including Australia, have not offered memberships to American broker-dealers. In Belgium and the Netherlands, foreign broker-dealers are prohibited from soliciting or taking any securities orders from most nationals. Foreign exchange restrictions imposed by foreign governments also hamper foreign participation in exchanges in France, Italy and Germany.[26] The Japanese have made efforts to change their rules to permit American broker-dealers and other foreign securities firms to become members of the Tokyo Stock Exchange. On November 29, 1985, they chose three American and three British securities firms as members, marking the first time foreign firms were allowed to join the Tokyo Exchange.[27]

Disclosure and other requirements in the United States are significantly more rigorous than those in other countries. Dealings by foreigners in U.S. securities are of legitimate concern to the SEC when they materially affect U.S. investors, corporations and securities markets. Although the U.S. markets have been the most open among those of major industrial countries, the United States is not alone in attempting to apply its national laws to transnational dealings. Attempts by other foreign governments to enforce their laws and regulations on transnational dealings include Canada's Foreign Investment Review Act (FIRA) and the European Community's so-called "Vredeling proposal".

Like FIRA, the European proposal would require disclosure by foreign corporations doing, or attempting to do, business in those countries. The passage of the Canadian Act in 1974 created a government body with authority to disapprove the acquisition of a domestic company by a non-Canadian. Some observers believe that FIRA had a noticeable impact on U.S. securities markets. During Subcommittee hearings in 1981, witnesses argued that the impact of Canadian economic nationalism has been to penalize U.S. corporations with Canadian holdings and to give Canadian purchasers an obvious and unfair advantage in the marketplace.[28] The European Community's "Vredeling proposal" would not attempt to discourage foreign investment. But it would require a non-European parent of a company located in Europe to furnish information to European employees regarding strategic business plans that could impact on those employees.

Along with internationalization have come increasingly more frequent calls for cooperation in harmonizing diverse disclosure and accounting standards. Many argue that uniform—or at least consistent—standards throughout the world would reduce the costs of raising capital and assist investors by facilitating comparability. They also believe that harmonization would prevent the flow of capital from being determined by differences in regulation rather than by economic factors. Numerous organizations are involved in these attempts to harmonize diverse disclosure and accounting standards. They include: the Organization for Economic Co-operation and Development, the Commission of the European Communities, the Inter-American Conference of Securities Commissions, the International Accounting Standards Committee, the International Federation of Accountants, the UN Commission on Transnational Corporations and numerous *ad hoc* conferences.

---

[26] Barbara S. Thomas, Commissioner, Securities and Exchange Commission, "Internationalization of the World's Capital Markets—Can the SEC Help Shape the Future?", An Address Before the International Bar Association, June 23, 1982.

[27] The U.S. firms are: Merrill Lynch Capital Markets; Goldman, Sachs & Company; Morgan Stanley & Company.

[28] *Impact of Canadian Investment & Energy Policies on US Commerce*, Hearings before the Subcommittee on Oversight & Investigations and the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 97th Cong., 1st Sess., June 19, July 9, August 6, 1981.

Others argue, however, that FIRA was rarely applied outside the petroleum industry and was considered by some a failure. In any event, its status has changed under the Mulroney government and it is now viewed as a dormant issue.

In the past, the Securities and Exchange Commission's approach had been one characterized by neutrality. Federal securities laws contain few provisions specifically distinguishing foreign and domestic issuers. Most of the provisions applicable to domestic issuers are applied equally to foreign issuers with only a few exceptions. For example, foreign issuers were not permitted until recently to use the short form for registration under the Securities Act of 1933. On the other hand, it is difficult to enforce compliance with margin requirements when U.S. securities are purchased by foreigners through non-U.S. commercial and investment banks.

The Commission's neutral posture was challenged. While some argued that the SEC should adhere to what it believes are the best disclosure and accounting practices for U.S. markets, regardless of the impact on foreigners or on harmonization efforts, others took the view that it should encourage the process of internationalization by developing and actively negotiating proposals for harmonizing disclosure requirements. Still others argued that the Commission could encourage other countries to dismantle barriers to the entry of U.S. participants in their markets by relying on foreign disclosure, accounting and auditing standards—instead of more burdensome U.S. standards—and that this might also have the effect of encouraging more offerings of foreign securities in U.S. markets. In their view, removing impediments to foreign issuers in U.S. markets would facilitate the efficient use of capital throughout the world and increase competition in the United States, thereby encouraging better performance by U.S. issuers. They also noted that when investors purchase foreign securities that are unavailable in U.S. markets, they do so on the basis of far less disclosure than they would have if the foreign securities were available in the United States. If foreign issuers were encouraged to register in the U.S. under more liberal requirements, U.S. investors would have more information than they now have when they purchase securities in foreign markets—although less than they receive regarding domestic issues—and would be protected by the liability provisions of the Federal securities laws.

The Commission appears to have been somewhat persuaded by these arguments. In 1982, the SEC eased certain disclosure requirements for "blue-chip" foreign companies who sell their securities in the United States, and adopted a change that would allow "world-class" companies to prepare abbreviated prospectuses for their securities. Nevertheless, the Commission's general direction was ambiguous in this area. For example, the SEC also approved a rule to increase the amount of public disclosure by smaller foreign companies listed in the National Association of Securities Dealers' Automated Quotation system, the over-the-counter trading network. This new rule, it was argued, was adopted to facilitate the Commission's investigations of falsifications by foreign companies. The overall impact of these apparently contradictory initiatives on foreign entry into U.S. markets and on investor protection was unclear.

Now, however, harmonization—especially between the United States, the United Kingdom, and Canada—appears to have become the goal of the Commission in the face of increased internationalization of the securities markets. The SEC has proposed two approaches to facilitate multinational offerings—the reciprocal approach and the common prospectus approach. Under the reciprocal approach, a group of countries would agree that a prospectus accepted in an issuer's domicile which meets certain standards would be accepted in each participating country. Under the latter, an acceptable common prospectus would be developed and simultaneously filed in each country.[29] According to its testimony before the House Telecommunications, Consumer Protection and Finance Subcommittee,[30] these proposals reflect the SEC's commitment to uphold investor protection and improve the regulatory process.

To enhance international cooperation the Commission created an Office of International Legal Assistance within its Division of Enforcement on May 28, 1985. It is to serve as liaison with foreign law enforcement and diplomatic officials. SEC Chairman Shad believes other countries, such as Australia and Japan, are trying to catch up with the U.S. in terms of marketplace regulation. As he testified: "They are sending delegations to talk with us about how to emulate the SEC's regulatory system. That is particularly true in England."[31] Roberto Mendoza, Executive Vice President of Morgan Guaranty Trust Company, stated at the same hearing:

> . . . the harmonization process which was referred to earlier is resulting again almost without exception in raising foreign standards, not in lowering U.S. standards, and foreign issuers are increasingly on a voluntary basis adopting U.S. disclosure requirements, if for no other reason than to have access to the U.S. capital markets. So we completely endorse the view that the harmonization process requires a raising of foreign rather than a lowering of our standards, and we think that market discipline is forcing that to occur.[32]

Many advocates of investor protection oppose overly accommodative responses to the internationalization of capital markets. They argue that foreign issuers should continue to be subject to the same disclosure requirements as U.S. issuers; that each country should determine the type of market regulation that best suits its national objectives, and that uniform standards are impossible to achieve because different socio-economic and historical factors dictate different types of markets. Thus, concerns with respect to harmonization should be accommodated where possible, but harmonization alone should not be a goal of regulation.

Furthermore, they note, increased internationalization requires a stronger emphasis on comparability. Investors need the same information whether the issuer is domestic or foreign. More liberal disclosure rules in this country may undermine, rather than promote, efforts to encourage other countries to improve their investor protection schemes. Moreover, if the relaxation of U.S. protections encourages more foreign issues and transactions in U.S. markets, the effect may be to increase, rather than reduce, barriers to entry by U.S. participants into foreign markets. It could also increase the potential for a "crowding out" of U.S. issuers. To encourage foreign offerings in the United States in the absence of reciprocal encouragement for U.S. issuers in foreign capital markets could reduce the share of U.S. and foreign financial investment devoted to capital formation by American companies. Meanwhile, the amount and quality of disclosure may decline world-wide as regulators compete to attract securities offerings. Alternatively, efforts to attract foreign issuers could create dual systems which would be unfair to domestic issuers and could undermine investor confidence in domestic markets.

---

[29] *Federal Register*, Proposed Rules of the SEC, Vol 50, No. 45, March 7, 1985, p. 9281.

[30] John S.R. Shad, Chairman, Securities and Exchange Commission, *Financial Restructuring*, May 2, 1985, *op. cit.*, p. 205.

[31] *Ibid.*, p. 264.

[32] *Ibid.*, p. 334.

In summary, advocates of investor protection argue that U.S. capital markets are the strongest in the world precisely because of our system of regulation, and that, given the key role of disclosure in that system, changes in disclosure requirements should only be based on persuasive economic or public policy objectives. While this argument has merit, it is clear that the implications of internationalization for the preservation of U.S. standards of investor protection cannot be ignored. Close coordination of standards and oversight among regulators in the major national markets and strategies to preclude the evasion of regulation in offshore markets will be necessary if problems and crises (like those that emerged as a result of rapid expansion of unregulated Eurobanking markets in the 1970s)[33] are to be avoided.

---

[33] See Part I, Chapter 3 and Part II, Chapters 1 and 2

CHAPTER 3: FINANCIAL GUARANTY INSURANCE PROGRAMS

AN OVERVIEW OF FINANCIAL GUARANTY INSURANCE PROGRAMS

Federal deposit insurance for commercial banks and thrift institutions was authorized in the 1930s after decades of debate and experimentation with state programs. The success of these funds in restoring confidence in depository institutions after the wave of bank failures in the early years of the Depression is seen by economists as the "most important structural change in the banking system" and a fundamental contribution to U.S. monetary and financial stability.[1] The growing perception of deposit insurance as the cornerstone of financial stability and its record in providing protection at minimal cost led to the creation in 1970 of Federal insurance funds for securities firms and credit unions, and state guaranty funds for insurance companies.

Deposit insurance

Although the share insurance fund administered by the National Credit Union Administration (NCUA) was a latecomer in terms of this form of protection, the basic structure of protection and of the fund's operations is patterned after that of the Federal Deposit Insurance Corporation (FDIC), which insures commercial banks and some mutual savings banks, and the Federal Savings and Loan Insurance Corporation (FSLIC) which insures thrifts. All three of these funds insure individual deposits up to $100,000; all generate income from assessments [2] and from income on investments in government securities rather than from appropriations, and all have authority to borrow from the U.S. Treasury.[3]

While originally intended for use in paying off depositors of failed insured institutions, the agencies' additional authority to undertake preventive actions has become the more usual form of assistance in recent years. The deposit insurance funds are now more often used to lend to acquiring institutions in what is termed a "supervisory merger" or "purchase and assumption" transaction—an acquisition arranged by the insurance agency to prevent failure—and to make loans to troubled institutions that have reasonable prospects for a return to profitability.

---

[1] Milton Friedman and Anna Schwartz, *A Monetary History of the United States*, 1963; quoted in *Deposit Insurance in a Changing Environment*, a Study of the Current System of Deposit Insurance Pursuant to Section 712 of the Garn-St Germain Depository Institutions Act of 1982, Submitted to the United States Congress by the Federal Deposit Insurance Corporation, April 15, 1983; p. vii.

The FDIC study also quotes John K. Galbraith (*Money: Whence It Came, Where It Went*, 1975): "The anarchy of uncontrolled banking [was] brought to an end not by the Federal Reserve System ('FRS') but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation . . . in all American monetary history no legislative action brought such a change as this." (*Ibid.*, p. vii).

[2] Currently, assessments are made at a rate of 1/12 of one percent of total domestic deposits in an insured institution. However, until recently the FDIC rebated that portion of assessments not used to cover expenses (including losses) and relied primarily on earnings from investments for growth of reserves. In 1984, members of NCUA voluntarily increased assessments to raise the ratio of reserves to deposits.

[3] Differences in borrowing authority vary relative to total deposits of insured institutions. The FDIC has statutory authority to borrow up to $3 billion; the FSLIC, $750 million and NCUA, $100 million.

The Securities Investor Protection Corporation

In this, as in other respects, the authority of depository institutions' insurance agencies differs from that of the Securities Investor Protection Corporation (SIPC). SIPC's reserves cannot be used to assist mergers or make loans to troubled broker-dealers; they can only be used to pay off customers in the event of insolvency. Moreover, protection extends only to the return of cash and securities to the customers of the failed firm, not to market losses even if they involve losses in the value of shares caused by a fraudulent transaction for a customer's account. While subject to SEC and Congressional oversight, SIPC is a private, membership corporation, not a government agency, and has no direct authority to borrow from the U.S. Treasury.[4] But, membership in SIPC is mandatory for all securities brokers that handle cash and securities for U.S. resident customers [5] while only Federally chartered depository institutions are required to be Federally insured.[6] There is, however, one point of resemblance. Like the depository insurance agencies, SIPC generates income from assessments and from earnings on investments in government securities.

State insurance guaranty funds

Protection for customers of insurance companies relies more heavily on "soundness" regulation such as the solvency requirements mandated by state regulation, including restrictions on the types of securities in which insurance companies can invest and laws and regulations governing capital and reserves.[7] All states now have property-casualty insurance guaranty funds but they are small relative to the size of industry obligations and may not be able to handle a major crisis. Most states do not have life insurance guaranty funds. Moreover, unlike the deposit insurance funds or SIPC, all but one of the state insurance guaranty funds are post-assessment funds. And even New York's fund—the only preassessment fund and the largest—is not restricted to investments in U.S. government securities. The New York guaranty fund had substantial investments in New York City municipal bonds during a severe city financial crisis and consequently the bonds were not sufficiently liquid to have covered a major insolvency or a number of small insolvencies in 1975 when many insurance companies were experiencing problems.[8]

---

[4] However, SIPC does have legislative authority to borrow up to $1 billion from the U.S. Treasury through the SEC if the SEC determines the loan is necessary for the protection of customers and to maintain confidence in U.S. securities markets under conditions imposed by the SEC (Kevin F. Winch, *Securities Investor Protection (SIPC): Customer Indemnification When A Securities Firm Fails*, Congressional Research Service, June 30, 1982, Report No. 82-125E, p. 4).

[5] *Survey of Investor Protection and the Regulation of Financial Intermediaries*, Study by the staff of the U.S. General Accounting Office, July 13, 1983, pp. 29, 37-39.

[6] In 1982 there were 5,143 depository institutions that were not Federally insured, most of which (4,115) were state chartered credit unions. The majority of these institutions are covered by state insurance programs (*Ibid.*, p. 34-36).

[7] As discussed in Part III, Chapter 1, insurance companies are regulated by the individual states.

The absence of federally guaranteed insurance protection was not thought to be as serious a problem for life insurance companies. A high degree of predictability based on actuarial analytical techniques and long experience permits life insurance companies to reserve against liquidity problems with some certainty—and, again, state laws and regulations governing reserves help prevent most problems. On the other hand, property and casualty insurance losses are not precisely predictable. On the property-casualty side of the insurance business, market forces perpetuate cycles of underwriting profitability and loss. Their customers are protected primarily by voluntary reinsurance mechanisms that spread the risk among a number of other insurance entities.

The degree of protection afforded policy holders has been questioned. The regulatory focus on solvency requirements under state law does not always prevent mismanagement or conflicts of interest when the insurer is part of a diversified holding company and, as the failure of Baldwin-United demonstrated, the consequences can be serious. Ironically, efforts to assist a troubled property-casualty insurer—Government Employees Insurance Corporation (Geico)—in 1975 were aided by a drop in claims brought as policyholders apparently decided that delays and legal problems would be more costly than foregoing payment.[9] Geico was saved from bankruptcy by a cash infusion arranged by the D.C. insurance commissioner involving the purchase of a new stock issue by other insurance companies. Its competitors were persuaded that a bankruptcy would cause major repercussions throughout the industry. But this form of protection can weaken an industry that is called on to provide funds during a period when economic developments are putting pressure on the industry as a whole, and Geico's financial difficulties were perceived by some to represent an extreme threat to the insurance industry by exposing the weaknesses of the state guaranty funds.

The Pension Benefit Guaranty Corporation

The Pension Benefit Guaranty Corporation (PBGC) was established under ERISA to insure basic benefits in cases where pension plans terminate without adequate funds to pay vested benefits. Prior to the enactment of ERISA in 1974, employers could terminate a pension plan without being held liable for additional pension contributions. If the plan was not adequately funded to redress all pension claims, participants had no legal recourse to demand that employers continue funding the plan.

---

[8] There is an important distinction between New York's guaranty fund which is a preassessment fund and that of all the other States which are postassessment funds in which the fund can assess domiciled companies a percentage of written premiums, usually two percent a year, to pay for claims of insurers which have been declared insolvent. Theoretically the postassessment funds should be able to generate substantial sums. However, the funds have yet to be tested with a crisis of major proportions. Because property-casualty insurers are subject to periodic cycles of underwriting profitability and loss, some industry analysts fear that successive rounds of assessments when many companies are experiencing financial vulnerability could further weaken these firms and perhaps result in a chain of additional insolvencies. On the other hand, the example of New York's liquidity problems illustrates a serious weakness of prefunded guaranty programs—their vulnerability to preemption for other financial emergencies a State may face.

[9] Geico (Government Employees Insurance Corporation) was near bankruptcy when a large drop in interest rates in 1975 lowered its return on investments, and payments on claims exceeded income from premiums. Its competitive strategy had relied heavily on investment income during a period of high interest rates to offset an expansion of assets based on lower rates and sales of policies to high-risk customers.

The PBGC is self-financing and Government-owned and is authorized to borrow up to $100 million from the U.S. Treasury. It covers all private sector defined benefit plans (not defined contribution plans) and, unlike most private insurance companies, the PBGC must accept all claims made against it, regardless of the financial status of the plan. The Corporation is financed mostly by flat premiums [10] paid by covered plans and also draws on the assets from terminated plans, investment income, and liability incurred by employers upon ending pension plans. In addition to financing the claims of terminated plans with insufficient assets, the premiums are also used to pay administrative expenses and amortize the PBGC's debt.

The PBGC now guaranties the pension benefits of approximately 38 million American workers who are covered by more than 112,000 plans. The pension plans of single employers and multiemployers are treated differently under the guaranty program. The former have been insured since 1974 while coverage of the multiemployer plans began in 1980. The PBGC insures benefits against risk of plan insolvency for the multiemployers, as opposed to insuring against plan termination for single employers. Separate reserve funds are maintained for each by PBGC. The delay in covering the multiemployer plans was caused by controversy over the appropriate design of the insurance program. During the time lapse, the PBGC was authorized to cover any terminations on a case-by-case basis.

In choosing the type of private pension plan to adopt, employers now tend to elect defined contribution plans. Some attribute this to ERISA complexities and requirements (of which the PBGC is one) that impact only on defined benefit plans. This trend concerns those who feel that defined benefit plans provide better retirement income protection for more employees than defined contribution plans which shift the investment risk to the individual participant.

EROSION OF THE RATIONALE FOR DIFFERENCES IN PROTECTION

The exclusion of securities and insurance companies from the original proposals for federal financial guaranty insurance programs is not surprising. New and experimental programs necessarily focus on areas where the need is greatest. A primary goal of the new deposit insurance funds was to protect small businesses and households, most of whom had placed their demand deposits and savings in depository institutions. Investments in securities and insurance protection were thought to be associated with more affluent individuals and large established corporations who could better afford loss or delay in recovering assets.

The second—but very important—goal of the new deposit insurance program was to "protect communities, states, or the Nation against the economic consequences of bank failure".[11] Losses or delays in recovering short-term transactions balances impair the ability of firms and individuals to meet payment schedules and may slow or even halt economic activity.

---

[10] The PBGC is studying the advantages and disadvantages of a graduated premium rate schedule based on risk.

While the historical experience explains differences in insurance protection, the rationale for these differences is now more open to question. A considerable share of the savings of persons of modest means is now held in pension funds, which barely existed in the 1930s. Life insurance companies now manage about half the assets in these funds, offer other savings vehicles such as annuities, and in addition provide 80 percent of all families in the U.S. with financial protection in the case of the death of a member,[12] and offer health and disability insurance as well.[13] Property-casualty firms have also become more directly involved with consumers over the years as other forms of insurance (homeowner, automobile, etc.) have become indispensible to households. Tax deferrals for Individual Retirement Accounts (IRAs) may encourage more moderate-income families to enter into longer-term investments in securities directly or through mutual funds. And mutual funds and securities firms now manage a significant portion of the nation's transactions balances held in money market funds. Thus insurance companies and securities firms meet more of the financial needs of American families and reach a broader spectrum of savers and investors now than in the past. As a result, there is reason to believe that a re-evaluation of the primary objective of the various financial guaranty insurance programs is warranted.

The effectiveness of current financial guaranty insurance programs in achieving their second objective--protection of the payments mechanism and of the stability and liquidity of the financial system—has also been undermined by structural changes in the system. The fact that money market deposit accounts (MMDAs) are insured, while money market mutual funds (MMMFs) are not, results in the exclusion of a substantial portion of readily accessible accounts from a form of protection traditionally viewed as necessary to maintain confidence in the payments mechanism. The exclusion of commodity futures accounts from coverage like that offered by SIPC for securities brokers' customer accounts also raises questions about the effectiveness of the role of financial guaranty insurance protection in reducing the chances for financial panics in the wake of the silver crisis and in view of the fact that both securities and commodity exchanges now offer options on financial futures.

---

[11] *Deposit Insurance in a Changing Environment*, op. cit., p. vii.

[12] Julius W. Allen, *The Changing World of Financial Intermediaries and Related Institutions: Survey of Major Developments and Their Implications for Public Policy*, Economics Division, Congressional Research Service, December 30, 1982, pp. 16-17.

[13] Purchases of life insurance in 1983 exceeded $1 trillion dollars, the life insurance in force also reached an all-time high of $4,965.9 billion and 86 percent of American families owned life insurance at that time. The breakdown of life insurance ownership for 1983 was: 51.2 percent holding ordinary (individual) policies, 44.7 percent covered by group plans, and the remaining 4.1 percent under industrial and credit life policies. At the end of 1982, 31 of the existing 2,060 life insurance companies were over 100 years old, held 60.2 percent of industry assets, and provided 43.9 percent of the life insurance in force. In contrast, the 25-50 year old companies provided 12.2 percent of the insurance and held 8.1 percent of the assets. (*1984 Life Insurance Fact Book*, the American Council of Life Insurance.)

In short, it has become more difficult, as former SEC Commissioner Bevis Longstreth has observed, to "draw the circle" around those financial transactions and assets that should be protected to achieve the original objectives of the various financial guaranty insurance programs.[14] Moreover, there is some concern that the various programs now in place may not be able to cope with the current problems of financial institutions and that they may even be counterproductive in promoting stability in an increasingly deregulated financial environment.

THE ADEQUACY OF FINANCIAL GUARANTY INSURANCE PROGRAMS

The Securities Investor Protection Corporation

When the Securities Investor Protection Act was passed in 1970, the statute required that SIPC establish a fund of at least $150 million through assessments. The minimum was reached in 1977 and assessments were reduced in 1979 to $25 a year each for the more than 7,000 member firms. As of January, 1986, the fund's assets were about $327 million.[15] Since 1978, SIPC's principal source of revenues has been income from its investments in government securities.[16] The estimated interest income on government securities for 1985 was $31 million.[17]

Based on past performance, SIPC's resources appear to be adequate to meet its responsibilities to replace missing securities by means of market purchases or make advances of up to $500,000 per customer account to meet claims for cash and securities.[18] It had conducted 189 liquidations involving over 140,000 customer claims through the end of 1985 and has been able to satisfy its "intent to compensate customers as quickly as possible so they can continue conducting their securities activities".[19]

The success of the SIPC program is the more remarkable considering the upheavals in the securities industry since its inception. No doubt much of that success is due to the additional protection afforded investors through regulation and as a result of margin requirements that act to limit the credit exposure of securities firms. Moreover, a number of securities brokers offer additional coverage (up to $2 million) provided through private insurers.

There are, however, some indications that SIPC's favorable experience to date cannot be projected into the future with complete certainty. As the earlier discussion of soundness issues suggests, the growing interdependence of firms and markets has already resulted in instances in which the failure of a single firm has significant effects on others. Crises in the silver and government securities markets in 1980 and 1982 could have seriously weakened a number of well-managed securities firms had the Federal Reserve not acted to prevent ripple effects.[20] SIPC's resources clearly would have been inadequate to deal with these crises in the absence of Federal Reserve intervention.

---

[14] Statement of Bevis Longstreth, Commissioner, Securities and Exchange commission, ***FDIC Securities Proposal and Related Issues***, *op. cit.*, p. 81.

[15] Theodore H. Focht, President, Securities Investor Protection Corporation, written testimony delivered before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, January 22, 1986, p. 9.

[16] *Survey of Investor Protection and the Regulation of Financial Intermediaries*, *op. cit.*, p. 39.

[17] *Ibid.*, p. 13.

[18] The amount of cash that can be replaced is limited to $100,000 to maintain parity with the level of protection offered to customers of depository institutions (*Ibid.*, p. 40).

[19] Theodore H. Focht, *op. cit.*, p. 11.

But, leaving aside crisis scenarios, it may be reasonable to consider reimposing SIPC assessments if only as an index against inflation. There are no statutory provisions governing the size of deposit insurance funds but the perpetuation of the existing rate of assessment tends to track the rate of growth of the industry and inflation. Such an approach for SIPC would appear prudent as well, given the high level of liquidations over the past decade.

Nevertheless, it is important to stress that securities brokers perform a function that is different than that of investment companies (mutual funds) or insurance companies and banks. They are not intermediaries in the sense of undertaking the responsibility for investing customers' funds. They act primarily as middlemen between sellers and buyers.[21] Securities brokers hold accounts for customers in a fiduciary capacity but the aggregate size of their accounts is small relative to the aggregate size of customers' funds held by other intermediaries. Because insurance would only be appropriate for these accounts, the size of the SIPC fund relative to that of depository institutions' insurance funds is not a good indication of the degree of protection offered. Moreover, regulations governing securities firms' net capital are more stringent than capital requirements for banks and are an important supplement to insurance protection.

Deposit insurance

The Federal Deposit Insurance Corporation insures deposits up to $100,000 for some 14,700 depository institutions. At year-end 1984, total deposits in FDIC insured institutions amounted to $1.4 trillion dollars. FDIC reserves—about $18 billion at that date—covered only 1.3 percent of the total, not all of which are eligible for coverage. The Federal Savings and Loan Insurance Corporation insures deposits up to $100,000 in some 3,167 institutions with total deposits of $785 billion at year-end 1984. Again, not all of the deposits in FSLIC insured institutions are eligible for coverage, but FSLIC reserves of $6 billion at year-end 1984 covered only 0.7 percent of total deposits and fell significantly below that level in 1985.[22]

---

[20] As discussed in Part II, Chapters 2 and 3, the Fed channels liquidity to other financial sectors and the economy as a whole through the banking system. It uses moral suasion to ensure that banks utilize the back-up of the discount window to supply credit to sectors requiring infusions of liquid funds.

[21] It may be useful to clarify the various functions of securities firms and note that only *brokerage* (in which the firm acts as a middleman between buyers and sellers of securities) is an appropriate function for insurance protection. The other two major functions of securities firms are underwriting securities and dealing in securities. The *underwriter* contracts to guaranty the sale of newly issued securities and agrees to purchase securities not absorbed by the market. (Underwriting on a "best efforts" basis where the underwriter does not assume any responsibility for unsold shares is a relatively recent innovation). A securities *dealer* buys and sells for his own account rather than for third parties. In practice, a securities firm may engage in all three functions but they are functionally different activities and are treated as such by regulators.

It should also be noted that *underwriting* and *brokerage* are primary functions of the insurance industry. For both the securities and insurance industries, underwriting implies risk bearing or assuming. In the case of the insurance industry, however, underwriting is the function viewed as appropriate for coverage by financial guaranty insurance protection.

[22] *Business Week*, April 1, 1985, p. 30.

In 1981-1982, the FDIC incurred losses amounting to about 70 percent of gross assessments compared with losses averaging about 9 percent of assessments in the period 1934-1980. In 1983-1984, losses exceeded gross assessments. Over the next several years, losses are also likely to be significantly higher compared with historical averages even if problems involving loans to developing countries and the agricultural and energy sectors are resolved, and because: "deregulation of deposit interest rate ceilings, expanded geographic competition, and other banking market changes are likely to increase risks in banking in general".[23] In fact, the rise in the number of banks identified by the FDIC as "problem" institutions is evidence that the threat has not receded. There were about 800 at year-end 1984, twice the level of the previous year and of the previous record of 378 banks in 1976, and the number of problem institutions had risen to 1,196 by March, 1986.

A large proportion of the FDIC's losses in 1981-82 were incurred in connection with assisted mergers of failing mutual savings banks. They amounted to about $1.4 billion. However, the FDIC is not the primary insurer of thrifts and its losses on savings institutions were smaller than those incurred by the FSLIC relative to the size of its fund (about $12 billion in this period).[24] The FSLIC's aid to nine savings and loan institutions in the first six months of 1981 cost the $6 billion fund about $930 million at the time assistance was provided, subsequently reduced to $350 million after the sale of assets.

In view of the size of this drain on its reserves and the scope of the crisis in the industry, the FSLIC changed the way it handled troubled institutions in mid-1981. It relied less on liquidations and direct payments to depositors as well as purchase and assumption transactions,[25] and more on arranged mergers that limited initial cash outlays and spread costs over future periods. As a result, from late 1981 through 1982 it was able to assist 98 S&Ls having total assets of $40.6 billion with an initial cost of $300 million and an estimated current value cost of $1.8 billion in 1983, including future payments from reserves spread over a 12 year period. Insolvencies were also prevented by lowering the reserve and net worth requirements of savings institutions.[26] Further assistance was provided to weak institutions under the Garn-St Germain Act's authority to create net worth certificates in exchange for FSLIC promissory notes. This form of assistance is virtually costless unless the institution fails.[27]

---

[23] *Deposit Insurance in a Changing Environment*, *op. cit.*, p. v-7.

[24] *Ibid.*, pp. v-5 and v-6.

[25] A purchase and assumption transaction involves transferring all liabilities (including insured deposits) and selected assets to another institution. The FSLIC's (or FDIC's) costs in such transactions result from its payments to the acquiring institution of the difference between the market value of the assets and the value of the liabilities transferred. (*The FSLIC Insurance Fund—Recent Management and Outlook for the Future*, Report to the Congress by the Comptroller General of the United States, October 14, 1983; Summary, p. 11).

[26] *Ibid.*, pp. ii-iv.

This was an effective preventive technique because S&Ls had strong cash flow. As the GAO report comments (p. iii), their largest expense—interest expense—is largely a noncash expense because most depositors do not withdraw the interest as it is earned.

[27] *Ibid.*, p. v.

The FSLIC does pay interest on the note to compensate for inflation and keep its value constant over time.

Despite the success of techniques for managing the thrift crisis, its pressure on both FSLIC and FDIC reserves was considerable. Even in 1983, the view of the FDIC was that, "the savings bank problem has not ended."[28] And the Federal Home Loan Bank Board stated that "a sharp, sustained rise in short term interest rates could significantly increase pressure on fund reserves".[29] Thrift insolvencies and their prevention cost the FSLIC over $2.5 billion in fiscal year 1984 (fiscal year 1985 estimates were over $3 billion)—up from $1 billion in 1983.[30] During the third quarter of 1984, 31 percent of all FSLIC-insured institutions were operating in the red. And, as noted, the FSLIC fund reserve ratio (fund reserves to industry deposits) fell from 2.12 percent in 1970 to 0.76 percent at the end of 1984,[31] and fund reserves fell to $3.9 billion at the end of fiscal year 1985.[32]

Meanwhile, as noted, the FDIC also expects its reserves to be under some pressure from problems involving the commercial banks that it insures. The total outlays in 1983—about $1.7 billion—were higher than in the previous two years and higher than average income from assessments. Outlays escalated in 1984 and the FDIC owed $3.5 billion to the Federal Reserve in notes taken on as part of the Continental Illinois rescue.[33] In the first half of 1985, 43 banks failed—more than half the 1984 record of 79 failures—[34] and by year-end 1985, the number of failures totalled 120. However, FDIC assets acquired in assisting banks did not soar in 1985 as they did in 1983 and 1984, and the Fund ended that year with $19 billion of reserves.

Although the FDIC believes "the Fund could absorb considerable loss for a period of a year or two without seriously compromising its adequacy—there is some level of loss that would be judged to impair [its] viability". In that case, "it would be necessary to re-evaluate the current method of funding the FDIC".[35] Moreover, it has proposed that its borrowing authority be increased from the level legislated in 1947 to "be more reflective of current exposure—because of the implications for public confidence and to provide a safety valve in the case of a banking crisis".[36]

Like the FSLIC, the FDIC has increasingly attempted to manage problem institutions by means other than liquidations and direct payments to depositors. It made extensive use of the purchase and assumption technique as a means for minimizing initial cash outlays, and has also provided longer-term promissory notes in lieu of immediate cash in a few cases. Even so, the need for immediate cash in purchase and assumption transactions that might involve large banks would be sizable. For example, Franklin National

---

[28] *Deposit Insurance in a Changing Environment*, *op. cit.*, p. v-7.

[29] *The FSLIC Insurance Fund--*, *op. cit.*, p. ix.

[30] *Budget of the U.S. Government, Fiscal Year 1986*. Executive Office of the President and Office of Management and Budget, Appendix, p. I-Y31.

[31] Robert Trigaux and David Barnes, "Gray Requests Increased Aid For Bank Board", *American Banker*, February 12, 1985, p. 3.

[32] Monica Langley, "Plan Would Let Outsiders Buy Troubled S&Ls", *The Wall Street Journal*, February 14, 1986.

[33] *FY 1986 Budget*, *op. cit.*, Appendix, p. I-Y21.

[34] James L. Rowe, "7 Banks Fail in a Day, Post-Depression Record", *The Washington Post*, June 1, 1985, p. C1.

[35] *Deposit Insurance in a Changing Environment*, *op. cit.*, p. v-8.

[36] *Ibid.*, p. v-9.

Bank had borrowed $1.7 billion from the Federal Reserve prior to the transfer of its assets and liabilities in 1974. The FDIC was required to reimburse the Fed for Franklin's borrowings which amounted to about 28 percent of its reserves.[37] It handled this demand on its limited resources by arranging to repay the Fed over a three year period, during which time it was able to liquidate most of the assets not transferred to the institution that acquired Franklin.[38]

The Franklin case raises other important issues related to the question of the adequacy of deposit insurance funds. Foreign deposits of U.S. banks are not insured. Nevertheless, foreign deposits account for between one-quarter and one half of the total deposits of the largest banks. Moreover, U.S. residents now hold about $180 billion of deposits in the foreign branches of U.S. banks, about 40 percent of these branches' total liabilities.[39]

When Franklin failed, it had $1 billion of deposits in its London branch, about half of which were deposits of other U.S. banks. Almost all these and other noninsured deposits (primarily domestic CDs and Federal funds) were withdrawn as they matured over the period from May—when Franklin's problems became widely known—to October, 1974, when the bank was sold to European American, a consortium of foreign banks. The size of the Fed's loan of $1.7 billion to Franklin reflects its efforts to keep the bank open until the uninsured depositors had withdrawn their funds. In its view, the scope of its assistance was required to prevent a generalized banking crisis because Franklin, like all international banks then as now, depended heavily on the interbank market for funding. When the FDIC reimbursed the Fed for its loan to Franklin, it in effect made direct payments amounting to $1.7 billion to uninsured depositors while transferring insured deposits to another institution. This was a most curious result in terms of the intent of the original legislation. Nevertheless, it saved the FDIC from even greater outlays since over half of the uninsured depositors were other insured U.S. banks.[40]

Much of the FDIC's success in managing the Franklin failure was due to the fact that no insured depositors withdrew funds. Had they done so, the bank could not have been sold and a liquidation would have been even more costly. In the case of Penn Square (July 1982), the FDIC decided that a liquidation was less costly in view of the poor quality of the bank's assets and because the amount of uninsured deposits was large relative to other institutions of comparable size. It closed the bank before uninsured deposits could be withdrawn, thus avoiding the possibility of having to reimburse the Fed for borrowings by Penn Square.

---

[37] The FDIC's reserves in 1974 were $6.1 billion (*Ibid.*, p. v-5).

[38] *Ibid.*, p. v-8.

[39] Federal Reserve Board, *Federal Reserve Bulletin*, Table 3.14, various issues.

About $110 billion (60 percent) of U.S. resident deposits in the foreign branches of U.S. banks are held by banks in the United States. The remaining $70 billion are deposits of other financial intermediaries (primarily money market and pension funds), non-financial companies and individuals.

[40] For a more detailed description of the Franklin case, see "U.S. Banks Abroad", *Financial Institutions and the Nation's Economy* (FINE Study), *op. cit.*, Chapter 9.

The dilemma faced by the Fed and FDIC in dealing with the failure or potential failure of large multinational banks has been widely recognized. As discussed in the FINE Study, the problem arises because foreign branches (unlike domestic and foreign subsidiaries or affiliates) are legally part of the domestic parent. It has been proposed that foreign branch deposits be insured, that they not be insured but that premiums be assessed on the same basis as for domestic deposits to reflect greater risk, and that private insurance be purchased (on either a voluntary or mandatory basis) to cover foreign branch deposits. All such "solutions" are fraught with problems. So far, none has gained widespread support.

The Continental Illinois crisis in May 1984 revealed that the FDIC's resources are inadequate to deal with the failure of a large bank. Continental was close to technical insolvency: its capital barely exceeded the value of its bad loans. While closing the bank would have required a pay-out of only $3 billion by the FDIC to insured depositors, the threat to other banks precluded such a possibility during the initial phase of the crisis.[41] But the fact that a $40 billion bank had only $3 billion of insured deposits has caused some to question the relevance of deposit insurance for large banks and others to propose a greater regulatory focus on the liquidity of banks' assets.

As the latter proposal suggests, there was another problem: disposing of Continental's huge portfolio of good loans. Even after an aggressive program of selling assets and letting loans run-off, the bank had only shrunk to $25 billion—a far larger volume of assets than could be absorbed by the FDIC's $16 billion of reserves or even by another bank. Unable to orchestrate a merger, the FDIC had no choice but to arrange a continuation of support from other banks and the Fed,[42] and use its own limited resources to inject capital to replace shareholder funds depleted by the write-off of bad loans. By this action, it guaranteed both insured and uninsured depositors, by becoming the principal shareholder in a multibillion dollar bank holding company.

The FDIC's action in the Continental Illinois case represents a broad interpretation of its powers under the Act to prevent the disruption of communities. It has been criticized by small banks as indicating a gross inequity in treatment of banks and communities based on size. Others argue that the bail-out was necessary to protect the banking system, and that the price was cheap in view of the enormous payout to insured depositors that would have ensued if closing Continental Illinois had resulted in other bank failures.

The Franklin and Continental Illinois experiences—as well as the size of U.S. resident deposits in foreign branches—raise serious questions about the ability of the FDIC to manage concurrent problems involving more than one of the larger international banks. As proved to be the case in both these crises, the Fed's role as lender of last resort would be critical in preventing the effects of a withdrawal of uninsured deposits from spreading to other banks.[43] In the case of the major money center banks, this could involve borrowings from the Fed well in excess of $10 billion on a daily basis.

---

[41] This assertion has been contested by staff of the House Banking Committee. However, it is the view of many analysts that the threat posed to the global banking system was much greater in the case of Continental Illinois than in that of Franklin National.

[42] At their peak, Federal Reserve Bank of Chicago loans to Continental Illinois exceeded $7 billion and averaged about $4 billion (daily) in the fall of 1984. Total support required was in excess of $12 billion—almost half the banks' assets after loan sales and run-offs.

[43] This is because the problem banks would have to withdraw funds from the interbank market to meet their liabilities to uninsured depositors, and would thus initiate a chain reaction of withdrawals by other banks. The result would be a significant contraction of the interbank market (Franklin precipitated a decline that mounted to 11 percent) that would jeopardize the ability of many banks to fund nonliquid loans already on their books, put pressure on banks not to renew maturing loans, and thus cause a significant credit contraction with an associated increase in interest rates that would further jeopardize the solvency of banks and weaken other financial intermediaries and markets.

But the Fed's loans would have to be repaid by the FDIC in the event that the bank had to be sold to another institution. And in the case of a liquidation or merger involving one of the larger banks, the FDIC would end up with a sizable volume of foreign loans. Normally, the FDIC is able to liquidate the assets it acquires at a discount and thus minimize the use of fund reserves in repaying the Fed. But foreign loans would be more difficult to liquidate and the FDIC would inevitably be drawn into rescheduling negotiations with developing countries.

In such a scenario, the FDIC's resources would be woefully inadequate. It would almost certainly be required to use its authority to borrow from the Treasury.[44] But the current statutory limit could, as the FDIC's report to Congress states, inhibit its ability to "provide a safety valve" in the event of a crisis of this magnitude. If the Fund's vulnerability became apparent, the public's confidence in the banking system could be seriously undermined. It is therefore likely that the Continental Illinois solution—providing capital support after a significant reduction in assets has occurred—would be used again in similar circumstances despite the degree of government intervention (virtual ownership) that it entails and the fact that it negates the "free market" model of regulation favored by the incumbent regulatory authorities.

State insurance guaranty funds

The state insurance guaranty fund system emerged in 1969 in response to a proposal for a federal insurance guaranty program. The objective of establishing a state guaranty fund system was to ward off a Federal program that insurers feared would lead to increased Federal scrutiny, and to avoid higher assessments under the proposed Federal system.[45]

Federal concern over mounting problems caused by a significant number of automobile insurer insolvencies first manifested itself in 1965 when Senator Thomas J. Dodd held hearings on insurance company failures and introduced his Federal Motor Vehicle Insurance Guaranty Corporation legislation.[46] In May 1969, Senator Warren Magnuson introduced a bill [47] to establish a Federal Insurance Guaranty Corporation that would provide for payment of claims of policyholders and claimants of insolvent property-casualty and surety insurance companies. In large part the proposed corporation was to be modeled after the Federal Deposit Insurance

---

[44] If Treasury resources were used to bail out banks, distinctions between the treatment of depository institutions and commercial corporations would be blurred. Some might view Treasury assistance as augmenting existing precedents for industrial policy. In any event, if the size of the troubled institution limits the options for providing assistance using resources currently available to the deposit insurance programs, it may be necessary to view large institutions as a special case and require higher capital-to-asset ratios and/or other safeguards to protect taxpayers from the consequences of liquidity crises or other problems.

[45] As has often been the case historically, Federal interest in insurance industry problems has stimulated the states to exercise increased or more conscientious regulation and supervision of insurance. The first state insurance guaranty fund association was established in November 1969 and most other state funds were in existence by 1972. New York and New Jersey established pre-funded "standing" funds but New Jersey converted its fund to an association that levies assessments after an insolvency in 1974.

[46] S.3919, 90th Cong., 1st Sess.

[47] S.2236, 92nd Cong., 1st Sess.

Corporation Act and also adopted certain provisions from Senator Dodd's proposal. The proposed Federal Insurance Guaranty Corporation would have had the power to examine the financial operations of all property-casualty insurers operating on an interstate basis and to coordinate this examination with those made by State regulatory authorities.[48]

The Federal system would have created a much larger fund than the state system which placed a cap on individual company assessments per year.[49] The effect of the cap has been to significantly limit the system's total capacity. For example, total capacity in the property-casualty area is $1 billion—not enough to cover a major insolvency in a segment of the industry where some large insurers routinely pay out more in claims in a single year.[50]

Although life and health insurers originally opposed the state guaranty fund system on the grounds that their industry had an excellent track record and because of their "belief that it was unfair to penalize policy-holders of well-managed companies to protect poorly-managed companies",[51] the insurance industry as a whole now believes that the system is "ill-equipped" to handle major insolvencies; that a "jumbo" insolvency would strain the system beyond its limits, and that a number of smaller insolvencies heavily concentrated in certain states would severely test the capacity of those states' guaranty funds. An *ad hoc* industry committee has developed several proposals for replacing or improving the current system, including a policyholder security account, a reinsurance corporation and a Federal guaranty proposal that—like earlier Federal proposals—would ensure the retention of state, rather than Federal, regulation and supervision but require less Federal scrutiny of the industry. Some spokesmen for the industry believe these improvements should also include mechanisms like those available to the deposit insurance agencies to assist mergers and prevent insolvencies.[52]

Developments in the reinsurance business are responsible for much of the concern about the adequacy of the guaranty fund system to protect policyholders having claims for which an insolvent insurer is liable. Reinsurers deal primarily with primary insurers and other reinsurance companies. The basic mission of reinsurance companies is to spread risk and increase capacity. But the dependence of primary insurers on a healthy reinsurance industry cannot be too strongly emphasized.

---

[48] After the inauguration of the State insurance guaranty funds, an Administration-supported bill was introduced in March 1970 that would have established a Federal Insurance Guaranty Program, to be administered by the Federal Insurance Administration under the aegis of the Secretary of Housing and Urban Development. This proposal was in the nature of a "backup" measure to cover claims not provided for by existing state insurance guaranty funds.

[49] Most state assessment requirements are pegged to the amount of business (premium volume) that an insurer does in a particular state.

[50] Michael P. Duncan (Counsel with Allstate Insurance and former insurance director of Illinois), quoted in "Regulation of Reinsurance in the United States", *National Underwriter*, August 26, 1983, p. 52.

Between 1969 and 1984 guaranty funds collected approximately $528 million from insurers and refunded almost $135 to member companies. This does not include assessments made under the pre-assessment funds in New York and New Jersey, who adopted the law in 1974. (*Special Report* of the National Committee on Insurance Guaranty Funds: State Insurance Guaranty Funds and Insurance Company Insolvency Assessment Information, p. 1.)

[51] C. Bowman Strome Jr. (Vice President and General Counsel, Equitable Society), quoted in *Ibid.*, p. 52.

Some (but not all) states have established life-health insurer guaranty funds. It has generally been accepted that some form of protection is necessary. The importance of such funds is enhanced in the case of insurers who are subsidiaries of diversified financial corporations where the assets of the insurer may be shifted to other corporate uses. However, the underlying objection persists: that well-managed companies should not unduly subsidize the failure of badly-managed insurers.

[52] *Ibid.*, pp. 2, 52.

A scandal involving Pritchard and Baird, a New York-based reinsurance intermediary, touched off some concerns in the mid-1970s. It was followed by a scheme to divert monies from Lloyd's of London syndicates, a reinsurance dispute involving a Panama company and the 1982 insolvency of a small Illinois company, Kenilworth, with world-wide repercussions. The losses involved in these scandals resulted in a growing recognition that reinsurance, once a trusted method for minimizing risks to primary insurers, may now be their Achilles heel.

Because reinsurance companies rarely deal directly with policyholders and constitute an industry that "has been perceived as involving sophisticated professionals far removed from the consuming public", states have had no role in supervising and regulating conditions of reinsurance transactions.[53] The antiquated "utmost good faith" doctrine has been the *modus operandi* between the ceding company and the reinsurer. Moreover, the only state that requires that reinsurance intermediaries be licensed is New York which had 229 licensed brokers in 1981.[54] The primary insurer—the ceding company—is not required to identify the reinsurer assuming some portion of its risk, and regulators often cannot determine the extent to which the primary insurers' solvency depends on reinsurance.[55] Frequently the primary insurer itself does not know the identity of all the players since a reinsurance company or a broker may pass off much of the risk to yet other reinsurers that, in turn, can cede to still others, creating a long chain that may be difficult or impossible to unravel in the event of an insolvency.

While the reinsurance industry has historically operated with a reasonably good track record on the basis of "good faith" for more than a century, excess capacity—the result of a rush of newcomers into the business in the 1970s—has radically changed the outlook. The first wave of excess capacity developed with the creation of "captive" insurance companies by U.S. industrial firms.[56] Many of the original captives were located in the Bahamas to avoid Federal taxation and state regulation and subsequently moved to Bermuda and the Cayman Islands when Bahamian laws and regulations were tightened. The use of captives enabled their parent companies to take tax deductions on, and/or delay, premium payments to their insurance subsidiaries. But the IRS ruled that tax benefits on premiums would apply only if 50 percent of the captive companies' business involved third parties. Much of the third party business undertaken by these companies to meet IRS standards was reinsurance business, and it is contended that much of it involved substantial risks "dumped" by brokers on unsophisticated captive underwriters.

---

[53] John C. Gurley, quoted in *Ibid.*, p. 53.

[54] "Scandals Rock Reinsurance Business: 'Good Faith' Becoming a Bad Gamble," *Journal of Commerce*, February 20, 1981.

[55] Edmond F. Rondepierre (General Counsel for General Reinsurance Company), quoted in *National Underwriter* August 12, 1983, p. 10.

[56] A "captive" insurance company is a legally separate subsidiary created to underwrite some or all of the parent company's or organization's known risks. Captives developed as a refinement of self-insurance techniques and give corporate risk managers flexibility and leverage to better deal with fluctuating insurance markets.

Additional "overcapacity" was created in 1980 and 1981 as smaller, independent newcomers entered the market, attracted by the industry's big cash flow at a time of high interest rates. The result was to depress premiums "to dangerously low levels" and increase the risk of "some embarrassing failures".[57] However, lower interest rates in 1983 and severe underwriting losses curtailed the amount of business the captives were willing to underwrite and slowed the entry of additional newcomers. These developments raised concerns about a possible "shake out" in the industry and whether some of the captives and newer companies would be around to receive and cover a client's losses.[58]

The market cycle described above is a classic "soft" market with overcapacity resulting in intense competition among insurers that depresses premiums and profitability. The insurance underwriting cycle has now turned; the market is hardening or tightening rapidly and capacity has contracted dramatically as manifested by severe problems of affordability and availability of needed coverages. These problems of affordability and availability of coverage in the commercial market have renewed interest in captives as a capacity-generating mechanism.

The scandals and problems in the reinsurance industry have prompted a number of proposals to regulate reinsurance contracts and extend requirements for licensing of intermediaries to other states. The health of the reinsurance industry is now seen as critical to the solvency of primary insurers and the viability of the guaranty fund system. The belief that arrangements between supposedly sophisticated insurance practitioners need not be supervised has been shaken. These perceptions are similar to those that have led to proposals to tighten up the regulation of banks' international lending. And, as in the banking industry, proposals to expand insurance regulation to areas not previously covered are being offered at the same time that proposals to loosen existing regulations on permissible activities are being implemented or considered.

Pension Benefit Guaranty Corporation

The PBGC is faced with a $1.3 billion gap between assets and liabilities, which includes an estimated $475 million in unfunded obligations unloaded by Wheeling-Pittsburg Steel in 1985.[59] The deficit is increasing for several reasons: 1) total annual claims have jumped dramatically; 2) authority to recover unfunded pension liability for plans from sponsors is limited; 3) minimum plan contributions by sponsors are deferred with IRS approval and remain unpaid upon plan termination; and 4) full insurance coverage is generally provided for benefits granted retroactively for past services that have received limited sponsor funding.[60]

---

[57] "The Day of Reckoning Delayed", *World Business Weekly*, October 12, 1981, p. 31.

[58] "Offshore Captives Plagued by Soft Market", *The Journal of Commerce*, September 1, 1983, p. 6 c.

[59] "Pension Welfare" (editorial), *The Wall Street Journal*, February 3, 1986, p. 20.

The increase in total annual claims reflects the fact that the average claim per terminated plan has risen exponentially. A large number of companies with insufficient assets are folding and laying their pension plan liabilities in PBGC's lap. There has been a dramatic increase in the value of guaranteed benefits, of which there is a maximum limit set by ERISA, but a substantial decline in the percentage of unfunded liabilities recovered from employers.[61]

When a plan is terminated and the sponsor obligated to help finance any deficiency in plan assets needed to meet guaranteed levels, the sponsor's liability is limited to 30 percent of net worth. This limits the PBGC's recovery ability in several ways. Thirty percent of net worth is insufficient to pay unfunded pension plan liabilities for sponsors continuing in business. The PBGC is unable to establish liabilities against companies that have divested portions of their businesses (including underfunded pension plans later terminated by financially weak sponsors). And finally, because many sponsors do not have positive net worth, the Corporation is precluded from sharing in the distributed assets.[62]

Another factor contributing to the deficits of the PBGC touches on the ability of the IRS to defer contributions to the plan during periods of business hardship. In many cases, deferred contributions are never collected and the result is higher claims against the Corporation. Disparities in coverage provided and funds collected for the insurance program also add to the mounting deficit. Benefits are fully guaranteed after a relatively short time while sponsors are allowed a longer period to fund the plans.

While the Corporation is required to maintain its insurance premiums at the lowest level consistent with carrying out its obligations, a case can be made for increasing the premium. The Corporation has strongly advocated a premium increase and loophole closing to deal with its mounting deficit. It has been suggested by the PBGC that the longer the increase is delayed, the larger the ultimate increase needed will be.

Both the House and Senate have passed measures to raise the annual premium paid by employers to help reduce the deficit, and have included provisions intended to deter underfunded plans from terminating and shifting their financial responsibilities onto the PBGC insurance system.[63] Based on the record to date and the forecast of future claims, the Corporation's ability to pay benefits is not now in jeopardy. However, the termination of a plan with un-usually large, unfunded vested benefits would necessarily worsen the situation.

---

[60] "Report to the Congress: Legislative Changes Needed to Financially Strengthen Single Employer Pension Plan Insurance Program", General Accounting Office, #HRD-84-5, November 14, 1983, p. ii.

[61] Ray Schmitt, "Pension Plan Insurance Premiums: Brief Review of Background, Issues and Options", Congressional Research Service Report prepared at the request of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, March 16, 1984, p. 6.

[62] GAO Report to Congress, *op. cit.*, p. v.

[63] Both the House and Senate must jointly concur in a resolution to raise the annual premium. The measure is not required to be signed into law, however, to take effect. The respective packages passed by each body in the 98th Congress were not compatible, agreement through compromise was not reached, and the annual premium which the PBGC can charge remained unchanged.

THE CONFLICTING GOALS OF DEREGULATION AND INSURANCE PROTECTION

Deposit insurance and the state guaranty fund system for insurance companies are closely linked to soundness regulation The intent of soundness regulation is to prevent failure. Financial guaranty insurance funds help to achieve that objective by maintaining public confidence in the regulated institutions. To a lesser extent and more consistent with their role as middlemen in transactions between investors and the commercial enterprises in which they invest, the surveillance of securities firms by self-regulatory bodies and the emphasis on meeting net capital requirements help prevent failures with a back-up insurance fund to maintain confidence in the institutions to whom the public entrusts funds to execute direct investment transactions involving securities.

The disclosure provisions of the Securities Act of 1933 were also designed to promote public confidence. But the focus was on securities markets, and primarily on transactions involving public investment in commercial and industrial enterprises. Financial institutions were not, initially, subject to the full disclosure provisions of the Act. Most securities firms were partnerships and their stock was not sold to the public. While required to register with the SEC, the disclosure of information about their financial condition was designed primarily for regulatory purposes rather than dissemination to the public. Life insurers were organized as mutual companies owned by policyholders while the stock of property-casualty companies was also closely held. Neither securities nor insurance companies issued bonds. Disclosure, therefore, was not applicable to these institutions. Bank stocks were more widely held but banks were explicitly exempted from disclosure. The result, discussed below, was a very different regulatory scheme for financial institutions compared with nonfinancial companies.

But even before consolidation propelled the issue of disclosure for financial intermediaries into clearer focus, these institutions had already become subject to a greater degree of disclosure. As shares in securities firms and insurance companies came to be held by a wider group of investors, and banks and insurance companies formed holding companies and diversified their activities, some financial institutions were required to provide almost as much information to investors about their activities as were commercial enterprises.[64] As a result, the rationale for exempting banks from disclosure weakened—particularly since banks' foreign branches, although legally and financially an integral part of the parent bank, were less closely regulated than the domestic activities of securities and insurance firms.

---

[64] There are, however, differences in types of disclosure for financial firms. As former Comptroller of the Currency C.T. Conover noted, securities firms in the early 1980s disclosed less information about their financial condition and more about enforcement actions, whereas banks disclosed more about their financial condition, with little or no disclosure about enforcement actions (*Proceedings, SEC Conference on Major Issues Confronting the Nation's Financial Institutions and Markets in the 1980s*, October 6–8, 1982, p. 15)

Deregulation has further strengthened the argument for offering investors in financial institutions the same degree of protection afforded those who invest in commercial and industrial enterprises. Interest rate deregulation has eliminated an important component of soundness regulation for depository institutions. The consolidation of financial functions has undermined the ability of individual regulatory agencies to supervise the combined activities of the institutions they were designed to protect. The trend toward conglomerates that combine both financial and non-financial activities tends to compound regulatory problems. It certainly argues for uniform disclosure for financial and nonfinancial enterprises.

Because there is an inherent conflict between disclosure and soundness regulation, the most difficult and far-reaching problems posed by deregulation relate to its impact on the insurance funds. As former SEC Commissioner Treadway noted, disclosure is designed to raise doubts, "which is contrary to the original idea of fostering public confidence through federal deposit insurance." [65] The Federal Home Loan Bank Board concurs: "Deposit insurance was designed for one regulatory structure, but a very different one is now emerging." [66] But the FHLBB believes the problem is immediate, not prospective:

> Partial deregulation . . . has created its own problems . . . The current system is unstable; without reform it threatens the viability of federal deposit insurance.[67]

Evidence of that threat is already visible as the previous discussion of the adequacy of financial guaranty insurance funds indicates.

But there is another side to the conflict between a regulatory scheme designed to raise skepticism through disclosure and one that relies on insurance to allay doubts. Those in favor of deregulating the financial services industry advocate reliance on market forces, rather than soundness regulation, to discipline financial institutions. Disclosure is seen as facilitating—financial guaranty insurance as obstructing—the free play of market forces. Even if investors, depositors or policyholders have lost confidence in soundness regulation as a means for preventing insolvencies, their incentive to shift funds from unsound to sound institutions is undermined by the implicit guaranty that financial guaranty insurance provides against loss and inconvenience. Moreover, the insured institution itself has little incentive to minimize risk if risk-taking goes unpunished. In addition, deposit insurance gives depository institutions a competitive advantage over other intermediaries in attracting funds because it offers the broadest coverage. For these reasons, many have concluded, along with former FDIC Chairman William Isaac, that: "Change in the deposit insurance system is central to the whole issue of deregulation." [68]

---

[65] James C. Treadway, Jr., Commissioner, Securities and Exchange Commission, "A Seamless Web: Banks, New Activities and Disclosure," Keynote speech to the Third Annual Seminar on Securities Activities of Banks, New York, N.Y., September 29, 1983, p. 7.

[66] *Agenda for Reform*, A Report on Deposit Insurance to the Congress from the Federal Home Loan Bank Board, Washington, D.C., March 23, 1983, p. 17.

[67] *Ibid.*, p. 17.

[68] Jayne A. Pearl, "Paying the Price", *Forbes*, December 5, 1983, p. 151.

One commentator who advocates modifying the deposit insurance system does not agree, however, that either disclosure or the proposals for reducing coverage (discussed below) will solve the problems that partial deregulation poses for the viability of Federal deposit insurance:

> I believe that disclosure is not the answer, because no other type of institution subject to the disclosure system has such huge short-term liabilities that are not backed up by a strong credit. Deposit insurance works for the consumer, but it does not maintain the confidence of the large uninsured depositor—witness Continental Illinois. Disclosure exacerbates instability in the banking system. The real answer is probably to *extend*, not diminish, the insurance system and develop regulatory mechanisms to make management of banks more conservative.[69]

While this view is one that has not yet been widely discussed in debates on this issue, the point is worthy of consideration in future discussions. Another is the possibility of providing unlimited Federally-sponsored coverage for non-interest bearing transactions accounts while providing a lower level of Federally-sponsored coverage for interest-bearing savings accounts and for savings invested in other interest-bearing financial assets offered through other regulated intermediaries, including assets held in mutual funds, annuities and defined contribution pension funds.[70] The rationale for such a proposal is to provide maximum protection for the payments system [71] and more consistent coverage for small savers.

PROPOSALS TO RECONCILE DEPOSIT INSURANCE PROTECTION AND MARKET DISCIPLINE

Recognizing that the current instability that has resulted from partial deregulation undermines the effectiveness of soundness regulation and deposit insurance as well as disclosure, the depository insurance funds and outside observers have offered a number of proposals to deal with the inherent conflicts between these two regulatory schemes. As implied by former FDIC Chairman Isaac's statement, most of these proposals focus on the deposit insurance systems. The consensus view is that state guaranty funds for insurance companies should be augmented and there is virtually no interest in modifying the insurance system for the securities industry (SIPC).[72]

The following is a brief outline of the major changes proposed so far. Much of the discussion is drawn from materials developed by the FDIC and FSLIC in response to a directive in the Garn-St Germain Act of 1982.[73] For the most part, the proposals seek some

---

[69] Excerpt from a letter to the Subcommittee from Stephen J. Friedman, June 5, 1985.

[70] For further discussion of this proposal, see Appendix D.

[71] Providing a high level of coverage for demand deposits will not tend to encourage their use as investment assets if they do not pay interest. Particularly during periods of rising interest rates, which are also periods of increased stress for financial intermediaries, depositors tend to reduce their holdings of non-interest bearing assets (cash).

[72] Proposals for modifying the Pension Benefit Guaranty system are discussed above.

[73] The views of the National Credit Union Administration Board are not included in this discussion. As their report makes clear, the special nature of credit unions—the fact that they lend

Continued

middle ground between preserving insurance protection and confidence and increasing risk and market discipline. No one has proposed that insurance coverage be abandoned altogether.[74]

Reducing deposit insurance coverage

It has been suggested that the maximum level of coverage be reduced from $100,000 to $25,000 or $10,000 on the grounds that the intent of the deposit insurance program was to protect the small, individual saver. But this ignores the fact that deposit insurance also covers demand deposits of households, businesses and other sectors, and that protection of the payments system is now seen by many as the most important function of both soundness regulation and deposit insurance programs. Moreover, it could be argued that individual IRA and Keough accounts held by families of average income levels will exceed $25,000 over time. In any event, such a proposal has little political appeal and would increase economic disruptions caused by bank failures since many small businesses and state and local government agencies hold transactions balances in excess of $100,000. None of the deposit insurance agencies have proposed that the maximum level of coverage be reduced.

For the most part, proposals for reducing coverage are an attempt to address the problem of *de facto* coverage of deposits over $100,000. As discussed, the preferred method of handling failing banks and thrifts is through mergers, purchase and assumption transactions and direct assistance. The effect is to guaranty payment of all deposits, whatever their size. The expenditure of insurance reserves in these transactions satisfies the second public policy objective of deposit insurance—"to protect against the destabilizing effect of bank failure" [75]—but is clearly inconsistent with provisions for limitations on coverage.

The FDIC report to Congress supports the continuation of purchase and assumption transactions. It argues that permitting failures (such as Penn Square) in which large depositors must wait for months or years to discover what percentage of their deposits in excess of $100,000 will be paid "would make more likely the occurrence of bank runs that would have destabilizing effects like those that the FDIC was established in 1933 to prevent." [76] Court battles in the wake of the Penn Square failure were seen as likely to tie up the funds of large depositors for eight years and led to estimates

---

only to shareholders and therefore are restricted to providing consumer credit—would make some of the proposals suggested for analysis by Garn-St Germain inappropriate. For example, the establishment of risk-related insurance premiums could be discriminatory because the requirement for a common bond among shareholders could result in determining risk factors on the basis of the socio-economic make-up of the group rather than types of investment (which are relatively uniform) or managerial competence.

[74] It should be noted, however, that some 4,000 state-chartered credit unions operate without federal deposit insurance and that many shareholders of Federally chartered credit unions believe that the loss of dividends due to insurance premiums outweighs the gains in protection. But while these shareholders believe credit unions could operate successfully without deposit insurance (and note that they did so for 36 years), they do not advocate repealing the deposit insurance systems for banks and thrifts. It should also be noted that shareholders in some credit unions have elected to increase the maximum level of coverage by supplementing Federal or state insurance systems with private insurance coverage. Moreover, the National Association of Federal Credit Unions opposed provisions in the 1984 Garn bill (S. 2181) that would have authorized uninsured membership shares for Federal credit unions.

[75] *Deposit Insurance in a Changing Environment, op. cit.*, p. xvi.

[76] *Ibid.*, p. xvi.

that they would end up with only 65 percent of uninsured funds.[77] The FDIC feared that handling other problem institutions in this way could precipitate a chain of withdrawals involving even sound banks.

As an alternative, the FDIC proposed that purchase and assumption transactions be structured so that only insured deposits and some fraction (75 or 80 percent) of uninsured deposits pass to the acquiring bank.[78] While the risk to large depositors would be greater, the degree of risk would be known, and their funds would not be tied up for an indefinite period. These factors, they argued, would prevent bank runs.

Critics of the proposal were not so sure. Former FDIC Chairman William Isaac wasn't sure either, and believed that introducing an element of risk that would prompt withdrawals from unsound banks was acceptable because "the majority of banks that are well run are the ones that will attract funds." [79] He suggested including the modified payoff plan in legislative proposals but believed the FDIC could take some action on its own.[80] For example, it could transfer a given percentage of uninsured deposits together with enough sound assets to cover the transfer and let the remainder of the payoff be determined by the amount of recoveries on nontransferred assets.

But the FDIC and FSLIC face another problem which is less tractible. The practice of breaking up jumbo deposits into $100,000 amounts placed with separate institutions has become more prevalent among money brokers and has recently spread to money market mutual funds. Such actions not only frustrate the intent of the modified payoff proposal, they pose a threat to the adequacy of insurance reserves because they increase the amounts of insured deposits in unsound banks willing to pay a risk premium to obtain funds, and shift the risk of earning higher rates on deposits to the Federal insurance agencies.[81]

Perceptions of the seriousness of this problem have prompted proposals that money brokers be regulated and that such practices be prohibited. So far, attempts to deal with the problem by changes in regulation have been frustrated. A challenge to FDIC and FSLIC regulations restricting coverage to $100,000 of total funds placed by any one broker regardless of whether or not accounts were placed for (and held in the names of) individual depositors was upheld in court. Subsequently, the bill passed by the Senate in September 1984 proposed to limit the acceptance of brokered deposits in relation to the depository institution's capital. While the House has not yet considered this issue, it is clear that reducing the risk to the insurance funds posed by brokered deposits will be a priority issue in attempts to reconcile deposit insurance with a greater role for market forces.

---

[77] Pearl, *op. cit.*, p. 151.

[78] *Deposit Insurance in a Changing Environment, op. cit.*, p. xvi.

[79] Pearl, *op. cit.*, p. 148.

[80] *Ibid.*, p. 151.

[81] A research paper published by the Federal Reserve Bank of New York found that "(1) heavy use of brokered deposits is statistically correlated with relatively weaker financial performance; (2) failed banks that obtain over five to ten percent of their funds through brokers tend to cost the FDIC more than other failed banks; and (3) nearly half the brokered money in savings and loan associations and a substantial fraction of that in commercial banks is in accounts well above the $100,000 insured limit" (Sherrill Shaffer and Catherine Piche, *Brokered Deposits and Bank Soundness—Evidence and Regulatory Implications*, Federal Reserve Bank of New York, Research Paper No. 8405, November 1984, p. 1).

Risk-related premiums

Variable-rate deposit insurance premiums that reflect differences in risk have received widespread support. It is argued that fairness alone demands that unsound institutions should be penalized for the risks they pose to the deposit insurance system by paying a higher share of the costs. While a few critics warn that the disclosure that a Federal deposit insurance agency had judged an institution less sound than its peers might cause runs on institutions, others discount this concern, believing that this information would only be of interest to large, sophisticated depositors who would either demand a higher return or decline to place uninsured deposits with institutions paying higher premiums.[82] If so, risk-related premiums could compound the problems now caused by breaking-up deposits into insured lots.

The FSLIC has supported the introduction of risk-sensitive insurance premiums.[83] It argued that the proposal is workable; that it need not reflect all types of risk or perfectly measure those selected as long as the measured risk exposure is "importantly related to failure" and "does not create perverse incentives for institutions to assume other risks—not used as a basis for premiums." [84] The "major measurable aspects of risk" in the FSLIC's view are interest rate risk, default risk and capital adequacy.[85]

The FDIC, on the other hand, has taken the position that while the theory is difficult to reject, implementation is impractical. Its report to Congress argued that establishing an "ideal" risk-related premium system—

> Would entail unrealistic data requirements and would require more advanced risk quantification techniques than are currently imaginable. Even if these problems could be overcome, the authority over banks that would then devolve on the FDIC—much of it necessarily judgemental in nature—is far greater than is tolerable for any governmental agency in an economic society based on free-enterprise principles.[86]

Nevertheless, the FDIC favored taking some steps in the direction of penalizing unsound institutions. It proposed to use the current assessment rebate system for the purpose.[87] The rebate normally amounts to 60 percent of assessments. Banks with capital ratios of less than three percent would not receive a rebate. Those with significant loan loss records would receive only half of the amount rebated to other banks. While the theory behind this limited scope program is also difficult to reject, it, too, is impractical. The amounts involved are too small to have a significant impact on banks' behavior. But like the FDIC's modified pay out plan, it is a strategy that could be implemented without Congressional approval.[88]

---

[82] *Proceedings, SEC Issues Conference, op. cit.*, pp. 10-11.

[83] *Ibid.*, p. 16.

[84] *The FSLIC Insurance Fund, op. cit.*, p. 174.

[85] *Ibid.*, p. 10.

[86] *Deposit Insurance in a Changing Environment, op. cit.*, p. xiv.

[87] *Ibid.*, p. xiv.

Private deposit insurance programs

Although there was at one time some support for widening the number of institutions that rely wholly on private insurance, interest in such proposals disappeared in the wake of the Ohio and Maryland thrift crises in the spring of 1985. But the use of private insurance as a supplement to Federal insurance guaranty programs continues to be discussed.

Securities brokers and credit unions offer precedents for the use of private insurance as a supplement to government programs and the FDIC and FSLIC have argued that, if there is a modification in current practices so that large depositors are not covered by Federal insurance, the demand for coinsurance will grow. The FDIC recommended to Congress that coinsurance be optional rather than required. Due to capacity constraints, it found "little reason to believe that comprehensive insurance programs can be made available from the private sector." [89] Even before the Ohio and Maryland crises, the FSLIC took the view that a complete private insurance program was not feasible. Nevertheless it took a more activist position on coinsurance. Its 1983 report argues that bringing market discipline to the depository institutions market may require that the coinsurance approach be developed to cover noninsured deposits and possibly some portion of deposits that are now Federally insured as well.[90]

Raising capital-to-asset ratios

The function of capital in cushioning losses has led many to suggest that some of the pressure on deposit insurance funds could be alleviated by strengthening the capital base of depository institutions.[91] Capital-to-asset ratios were not fixed by law or regulation in the past. But a steady decline from an average level of 10 percent in the early 1960s to five percent—and even less in the case of the large multinational banks—led some regulators, analysts and Members of Congress to propose that minimum requirements be established. And, taking these proposals one step further, some have urged that capital requirements be used as leverage in reconciling the incompatability between the objectives of deposit insurance and market discipline, either as a supplement or alternative to modifying the insurance system.

Former FDIC Chairman Isaac proposed, for example, a phase-in of capital-to-asset ratios of up to 10 percent. Given the depressed levels of bank stocks, his proposal would have allowed half of banks' new capital to be funded with subordinated debt.[92] The FDIC report argued that increasing the amount of funding supplied by subordinated creditors would enhance market discipline. These lenders tend to be more sophisticated than depositors, cannot pull out their funds without incurring losses, and cannot count on being bailed-out when a bank fails. Moreover—unlike stockholders—their return on risk is fixed and they therefore receive no benefit if additional risk-taking results in higher profits. These factors could be expected to make subordinated creditors a potent force in influencing bank behavior if banks' growth were dependent on their willingness to supply funds. While the FDIC report did not recommend this approach as an alternative to modifying the insurance system, it argued that raising the level of subordinated debt would provide a protective cushion to the FDIC and is worthy of serious consideration.[93]

---

[88] Pearl, *op. cit.*, p. 148.

[89] *Deposit Insurance in a Changing Environment*, *op. cit.*, p. xvii.

[90] *The FSLIC Insurance Fund . . .*, *op. cit.*, p. 11.

[91] For an earlier discussion of this issue, *See* Donald D. Hester, "Opportunity and Responsibility in a Financial Institution", *Compendium of Papers Prepared for the FINE Study*, *op. cit.*, Book I; and Jane D'Arista, "U.S. Banks Abroad", *Ibid.*, Book II, pp. 905-907.

[92] Pearl, *op. cit.*, p. 151.

SUMMARY OF POLICY CONCERNS

The major proposals for modifying deposit insurance programs reveal continuing support for the belief that protecting depositors is a necessary corollary to maintaining confidence in depository institutions. The FDIC's suggestion that its authority to borrow from the Treasury be increased underscores the impression that it has not discounted the importance of depositor confidence. Its report repeatedly affirms that bank runs remain a potent threat to economic stability if the public loses confidence in banks or in the deposit insurance system.

But the reports submitted to Congress by the FDIC and FSLIC also make clear their belief that the system is less stable than in the past and the risk to the deposit insurance funds greater. The behavior of sophisticated investors indicates that at least that segment of the public has lost confidence in soundness regulation, if not in the willingness of the government to honor its insurance obligations. By placing deposits in several institutions so that all their total deposits are insured, large investors can exploit a higher level of systemic risk to earn higher returns at the expense of the deposit insurance agencies. It is true that this practice has introduced one element of market discipline into the system: unsound institutions generally pay a higher return to attract funds. But unsound institutions can now attract a larger volume of insured deposits through brokers and that increases the total amount of insured deposits that are at risk.

Sophisticated investors not only undermine the insurance program as presently constituted, they undermine proposals for introducing increased market discipline as well. Increased disclosure can only assist their efforts to identify problem institutions that will pay a higher return. Risk-related insurance will do the same. The modified payoff proposal will only work if uninsured deposits are at risk, but its introduction could increase the incidence of parcelling out deposits into insured deposits in the system. All these mechanisms will increase the costs of funding for unsound institutions without reducing risks to the insurance system. Meanwhile, the proposal for increasing the deposit insurance agencies' authority to borrow from the Treasury could also have perverse effects. It would reaffirm the belief that the government will continue to protect depositors in unsound institutions. And more of the costs of financial instability would be borne by taxpayers, less by banks. So far, the proposal for higher capital ratios funded by subordinated debt appears to offer the best hope for devising a strategy that increases market discipline and discourages risk without abandoning or significantly reducing deposit insurance coverage.

---

[93] *Deposit Insurance in a Changing Environment*, op. cit., p. xviii.

Some observers take the view that the degree of instability in the financial system and risk to the financial guaranty insurance system argues against escalating risk by further deregulation. Proponents of deregulation discount this view, arguing that the current level of systemic instability and risk to the deposit insurance funds is the result of partial deregulation which has eroded bank profits. In their view, additional deregulation—*i.e.*, less soundness regulation and increased competitive opportunities resulting from an expansion of banks' functions—will increase bank profits and lower the level of risk to the system and the deposit insurance funds.

Some who are neither proponents nor opponents nevertheless believe deregulation has and will create problems that cannot be resolved by mere reliance on disclosure, functional regulation, separate subsidiaries or modifying deposit insurance programs. Basic concepts concerning differences in financial functions and regulatory schemes must be reexamined.

This report takes the latter view. It finds that changes in financial structure have tested the applicability of existing regulatory strategies and may have eroded their ability to maintain stability and contain risk. This, however, is not a development that can be viewed with benign neglect. Because of the Government's extensive potential exposure in the event of a financial crisis,[94] the fragility of the financial system must be viewed as a major issue of national policy. Congress must therefore take an active, rather than reactive, role in formulating public policy for financial restructuring, to preserve the stability and soundness of the system, promote public confidence and facilitate economic growth.

---

[94] The Federal Government's potential exposure extends beyond the financial guaranty insurance programs to include the other, numerous credit and guaranty programs discussed in Part II, Chapter 1. In the event of a major financial crisis in the banking system, for example, almost all markets—and, thus, almost all types of claims on the Government for insurance and credit guarantees—would be affected.

BLANK PAGE

APPENDIXES

APPENDIX A: CREDIT ALLOCATION IN THE 1970s

Although persistent and rising inflation in the 1970s clearly had a major impact on investor decisions and thus on the allocation of credit, its effects occurred in the context of an existing allocative structure which tended to moderate the impact of inflation for some sectors. While the housing sector experienced severe cyclical downturns as disintermediation shifted funds away from savings deposits in periods of high or rising interest rates, it tended to rebound strongly when interest rates fell and, for the decade as a whole, housing and homebuyers fared better than commercial sectors.

The behavior of savings flows in the 1970s helps explain why housing outperformed the business sector. In 1970, time and savings deposits in banks and thrift institutions accounted for 18 percent of total outstanding U.S. financial assets and rose to 24 percent by year-end 1980. By contrast, the market value of corporate stocks fell from 38.1 percent to 27.6 percent of total outstanding financial assets over the same period. The share of corporate bonds in the total stock of financial instruments remained constant at 8.5 percent but foreign bonds (which are included in the total) accounted for an increasing share of bonds sold in U.S. markets.

Table 14 shows the dollar amount and percentage increases for selected financial instruments for various time periods. A substantial portion of time and savings deposits supply the funds for investment by intermediaries in mortgages. The dollar amount of increase in savings deposits and mortgages in the 1970s was greater than for any other type of financial instrument. Savings deposits and mortgages also increased relative to most other financial assets in the 1960s as well. This, too, indicated a favorable result for the same credit allocation techniques which were, in fact, adopted in the 1960s to counter a less favorable financial environment for housing in the 1950s. But the increase in the market value of corporate stocks in the 1960s was almost twice as great as the increase in the value of outstanding mortgages. In the 1970s, the rise in equity values was almost a third lower than the increase in outstanding mortgages.

Table 14: Increase in Stocks of U.S. Financial Assets For Selected Periods
(in Billions of Dollars and Percent)

	1961-1970		1971-1975		1976-1980	
	$ Amt	%	$ Amt	%	$ Amt	%
U.S.Treasury Securities	102.3	35.7	188.1	48.4	353.7	61.3
Bonds & Notes	55.1	27.7	83.5	32.9	250.4	74.2
Marketable short-term issues	47.2	54.2	84.6	63.0	123.3	56.3
U.S. Govt Agency Securities	43.0	494.3	69.1	133.6	185.8	153.8
State & Local Govt Securities	73.6	103.9	79.4	55.0	106.3	47.5
Corp Bonds (Non-financial)	92.0	122.2	87.0	52.0	113.1	44.5
Foreign Bonds	8.3	143.1	11.2	79.4	22.3	88.1
Corp Equities						
New Issues	53.6	NA	52.3	-2.4	41.2	-21.2
Change in Market Value, outstanding issues	456.0	101.1	-15.3	-1.7	583.7	55.4
Time & Savings Deposits	265.5	151.7	360.6	81.8	583.4	72.8
Demand Deposits	62.9	52.9	51.6	28.3	74.1	31.6
Money Market Securities[a]	60.3	7[illegible]3.4	101.2	149.0	199.7	118.1
Mortgages						
Total	264.2	126.5	328.4	69.4	650.3	81.1
Home	155.8	109.8	193.1	64.8	469.6	95.7

NA = Not available

---

[a] Includes large negotiable certificates of deposit issued by commercial banks, securities repurchase agreements issued by commercial banks and savings institutions, bankers acceptances and commercial paper.

Sources: Federal Reserve Board, Flow of Funds Accounts; Federal Reserve Board, Flow of Funds Outstanding, Federal Reserve Bulletin, February 1985

The rise in inflation was certainly an important element in this shift. Inflation erodes the market value of outstanding financial assets and increases the market value of real assets. As inflation progressed, housing prices rose, inflating the dollar value of new mortgages, while the dollar value of outstanding stocks fell. But, as discussed, inflation cannot explain the relative increase in time and savings deposits used to finance new mortgage lending. That development clearly reflects the influence of allocative techniques based on regulatory and tax policies and Federal credit programs—a highly successful and coordinated effort to channel savings into institutions structured to lend to a specific sector of the economy.

This does not mean that all the goals of the housing program were met. A visit to the South Bronx or similar sections of many other American cities will indicate that the objective of improving housing for low-income families failed despite the extraordinary scale of investment in real estate. Nor did this program prevent a growing number of families from being priced out of the housing market. But this failure does not diminish the success of the allocative technique itself, particularly in view of the inflationary environment with which it had to contend.

The effects of inflation are clear, however, in comparing the rise in financial assets in the 1970s compared with the 1960s. Much of the rise in the dollar value of various instruments merely reflects inflation. But the data do show that net new issues of corporate stocks declined in the second half of the decade despite the rebound in the market value of outstanding issues, and show a decline in the percentage increase in domestic corporate bonds as well. This clearly was a blow to capital formation in a period when rising energy prices eroded profits and thus diminished corporations' ability to use internally generated funds for capital investment.[1]

Inflation also explains the relatively small increase in demand deposits in the 1970s. Typically, investors are unwilling to hold a large amount of cash during periods when inflation and nominal interest rates are rising. This would also tend to explain the sharp rise in private money market securities[2] which are interest-bearing near-money assets. But data on changes in demand deposits and money market securities indicate that their relationship is not as close as might be expected. There is a closer relationship between changes in foreign holdings of Treasury bills and changes in the amount of outstanding money market securities.[3]

Foreign governments invested new dollar reserves in U.S. Treasury securities in the 1970s, two-thirds of which were created by intervention in foreign exchange markets by central banks in major industrial countries—primarily Germany, Japan, Switzerland and the United Kingdom—and one-third of which were investments of the surplus funds of OPEC countries. The inflow of foreign official funds not only expanded the supply of credit to U.S. borrowers (See Appendix B) but changed the portfolio mix of U.S. investors as well.

Because foreign governments preferred short-term issues, private U.S. holdings of Treasury bills declined. Small savers switched from Treasury bills to time and savings deposits. More affluent individuals and institutional investors bought private money market instruments as substitutes for Treasury bills.[4] But having lightened their load of short-term government issues, U.S. investors increased their holdings of marketable longer-term governments to maintain prudent risk ratios, and reduced their holdings of long-term corporate stocks and bonds.[5] As a result, the interest differential between short- and long-term private securities widened, encouraging private borrowers to borrow short and thus stimulating additional issues of short-term securities.

---

[1] Edwardo G. Mestre, "New Trends in the United States Capital Markets", *Capital Markets Under Inflation.* Edited by Nicholas Bruck: Buenos Aires Stock Exchange in cooperation with the Inter-American Development Bank, Washington, D.C., 1982, p. 197.

Mestre, Vice President for International Corporate Finance, Salomon Brothers, notes that U.S. corporate profits as a percentage of business revenues dropped from 17 percent in the 1950s to 13-15 percent in the 1960s and fell to below 10 percent in the 1970s. The retention of earnings for expansion fell from a high of five percent in the 1960s to only one percent in the 1970s.

[2] Included in this category as shown on Table 14 are large negotiable certificates of deposit issued by commercial banks, securities repurchase agreements issued by commercial banks and savings institutions, bankers acceptances and commercial paper.

[3] The hypothesis outlined here is the result of a preliminary analysis of flow of funds and interest rate data for this period including changes in stocks of financial assets and acquisitions by U.S. and foreign sectors. For an analysis of foreign flows, see Appendix B.

[4] Foreign demand for Treasury bills raised the price and lowered the return on these issues relative to private instruments with similar maturity structures and encouraged U.S. investors to sell bills and shift into other assets.

[5] This behavior does not apply to small savers who typically hold non-marketable savings bonds. The rate of increase in holdings of savings bonds dropped sharply in the 1970s as small savers increased their holdings of time deposits. But this also tended to increase the amount of long-term government debt held by more affluent individuals and institutional investors.

Some of the allocative effects of these portfolio shifts are shown in Table 15. Despite the increase in short-term instruments, corporate borrowing as a share of total credit flows declined in the period 1975–1979 to the lowest level since 1950. This is in part because a substantial amount of the proceeds of CDs were loaned by banks to their foreign branches and because the non-banking affiliates of bank holding companies increased their share of commercial paper issues to expand credit card operations which are largely financed in this market. As a result, borrowing by households rose significantly. There were also significant increases in borrowing by the Federal government and the foreign sector.[6]

---

[6] The data on foreign borrowing includes only direct borrowing in U.S. markets. It excludes loans by banks to their foreign branches or U.S. resident deposits in the Eurodollar market which are deducted from flow of funds data on funds supplied in U.S. markets.

TABLE 15 AVERAGES OF ANNUAL RATIOS OF FUNDS RAISED BY SELECTED SECTORS TO TOTAL FUNDS RAISED IN U.S. CREDIT MARKETS AND TO GNP: IN PERCENT, 1950-1984

	As a Percentage of Credit Market Funds Raised by Non-financial Sectors*				As a Percentage of Nominal GNP		
	Corporate Sector	Household Sector	Federal Gov't Sector	Foreign Sector	Corp. Sector	Household Sector	Federal Gov't Sector
1950-4	28.9	40.6	8.6	1.5	2.4	3.4	0.7
1955-9	31.5	43.7	6.5	2.9	2.6	3.8	0.3
1960-4	24.5	41.9	7.6	5.1	2.3	4.0	0.8
1965-9	34.6	34.1	6.6	3.5	3.6	3.5	0.9
1970-4	36.6	31.1	9.3	3.9	5.0	4.4	1.2
1975-9	23.3	36.1	21.1	6.3	3.8	6.1	3.0
1980-4**	21.0	32.4	27.9	4.3	2.9	4.9	4.1

SOURCE: Federal Reserve Board, Flow of Funds Accounts

*Includes equitites

**1980 to 3rd Quarter of 1984

Because the ratio of total credit flows to nominal GNP rose sharply in the 1970s—an indication of the extent to which credit expansion, fueled by net foreign inflows, contributed to inflation [7]—there were substantial increases in borrowing by all sectors. But the flow of funds to the corporate sector relative to nominal economic activity in the period 1975-1979 was only marginally higher than in the period 1965-1969 while borrowing by households and the Federal government in relation to nominal GNP rose to historically high levels. The net inflows of foreign funds that financed a burgeoning U.S. trade deficit throughout most of this period also financed an increase in consumer borrowing. But much of this borrowing was used to purchase imported consumer durables and exacerbated the rise in the trade deficit.

While the interaction of these factors—inflation, a government directed allocation program and international capital flows—is only part of the complex web of developments in U.S. financial markets over the last decade, it is an important part of the story and points up the need to understand the contributions of financial structure and allocative mechanisms in influencing macroeconomic events.

---

[7] See Appendix B.

APPENDIX B: SOME EFFECTS OF INTERNATIONAL CAPITAL FLOWS ON U.S. CREDIT MARKETS

A rough indication of the impact of international capital flows on U.S. financial markets can be gained from comparing foreign and domestic investment and borrowing in the U.S. domestic market. The following is an attempt to outline some of the ways in which foreign flows have influenced domestic credit flows over time, with particular emphasis on the years 1969 through 1981, and with foreign and domestic sources and uses of funds expressed as ratios of nominal GNP (see Table 16). While foreign flows became a focus for concern in the 1980s, these data indicate that their impact on U.S. financial markets and the U.S. economy was no less significant in the 1970s. For example, the comparisons in Table 16 show:

TABLE 16.—FUNDS RAISED/SUPPLIED IN U.S. CREDIT MARKETS [1] BY DOMESTIC AND FOREIGN SECTORS AS A PERCENT OF GNP

	Total flows	Foreign flows		Domestic flows		U.S. Government		U.S. private	
		Raised	Supplied	Raised	Supplied	Raised	Supplied	Raised	Supplied
Averages for period									
1960-64	9.2	0.4	0.4	8.8	8.8	0.8	0.7	8.0	8.1
1965-68	10.3	.4	.3	9.9	10.0	1.0	1.1	8.9	8.9
1969-74	12.4	.5	1.1	11.9	11.3	1.0	.9	10.9	10.4
1975-78	16.0	1.0	1.2	15.0	14.8	3.7	1.2	11.3	13.6
1979-81	14.5	1.0	.5	13.5	14.0	2.5	1.2	11.0	12.8
Averages for years									
1969	9.6	0.3	1.4	9.3	8.2	-0.4	0.8	9.7	7.4
1970	9.6	.3	.3	9.3	9.3	1.2	.8	8.1	8.5
1971	13.2	.4	2.0	12.8	11.2	2.3	1.1	10.5	10.1
1972	14.0	.4	1.0	13.6	13.0	1.3	.2	12.3	12.8
1973	14.7	.5	.3	14.2	14.4	.6	.9	13.6	13.5
1974	13.1	1.1	1.5	12.0	11.6	.8	1.3	11.2	10.3
1975	13.0	.7	-.2	12.3	13.2	5.5	1.5	6.8	11.7
1976	15.3	1.1	.6	14.2	14.7	4.0	1.1	10.2	13.6
1977	17.4	.7	2.2	16.7	15.2	3.0	.9	13.7	14.3
1978	18.4	1.6	2.1	16.8	16.3	2.5	1.2	14.3	15.1
1979	16.3	.8	.8	15.5	15.5	1.6	1.3	13.9	14.2
1980	13.6	1.1	-.1	12.5	13.7	3.0	1.1	9.5	12.6
1981	13.7	1.1	.7	12.6	13.0	3.0	1.2	9.6	11.8

[1] Excludes equities.

Source: Federal Reserve Board, *Flow of Funds Accounts*.

The impact of foreign flows on the volume of credit.—Net foreign flows change the amount of credit raised by domestic borrowers. In the period 1969 through 1974, cumulative net foreign inflows increased the total amount of funds supplied to domestic borrowers by an amount equal to 0.6 percent of the average level of nominal GNP over the amount supplied by domestic investors. In the period 1979 through 1981, however, credit market funds raised by domestic borrowers fell relative to domestic investment by an amount equal to 0.5 percent of the average level of nominal GNP.

Increased volatility in credit flows.—Foreign flows are very volatile and their effects on U.S. credit markets were stronger in individual years than average levels for selected periods. Total borrowing by domestic sectors in U.S. credit markets was greater than total funds supplied by domestic investors by an amount equal to 1.1 percent of nominal GNP in 1969, 1.6 percent in 1971 and 1.5 percent in 1977. But domestic borrowing fell relative to domestic investment by an amount equal to 0.9

percent of nominal GNP in 1975, 1.2 percent in 1980 and 0.4 percent in 1981. Despite a significant increase in government borrowing as a share of GNP in 1971, private domestic borrowing was larger than U.S. private investment by an amount equal to 0.4 percent of nominal GNP.

The contribution of foreign flows to credit expansion and inflation.—Sharp increases in the ratio of total credit to GNP in 1971 and 1977 suggest that excessive credit expansion, fueled by net foreign inflows, was a primary stimulus to inflation. Had credit expansion merely accommodated inflationary pressures, increases in the ratio of credit to nominal GNP in the 1970s would have been substantially smaller. Such sizable spurts in the ratio as occurred in these years suggest that credit expansion significantly outpaced the rise in prices and thus contributed to inflationary pressures.

An amplification of policy initiatives.—Net foreign inflows are associated with increases in domestic borrowing relative to GNP and net outflows with a decline in the ratio. This does not mean that changes in foreign flows are the dominant influence on U.S. credit flows, but it suggests that net foreign flows have tended to respond procyclically to domestic influences in most years in the 1970s, with larger net inflows during periods of monetary ease and net outflows in the wake of a more restrictive monetary policy. Thus, net foreign flows increased the amplitude of monetary policy initiatives, resulting in a greater expansion or contraction of credit than would have been the case in their absence.

The absence of offsetting responses.—Therefore, as a comparison of the ratios of funds raised and supplied by the U.S. private sector before and since 1969 suggests, monetary policy tools that rely on steady growth in bank reserves and in the amount of funds supplied to credit markets by the central bank will have less influence on the scale of private domestic borrowing and investment under conditions of financial interdependence. On the other hand, it could be argued that, although other channels for lending by the U.S. government—particularly lending by Federal agencies to the housing market—also contributed to the amount of funds supplied by the public sector, the absence of a significant change in the ratio of funds supplied by this sector implies that the Federal Reserve did not adhere to a policy of steady *real* growth in money and credit in the 1970s; it accommodated the rise in nominal GNP. But the absence of a significant change in this ratio also implies that changes in the amount of funds supplied by government agencies and the Federal Reserve since 1969 have not been the only channel for the expansion and contraction of credit that is reflected in the more volatile ratios of total credit to GNP in these years. It does suggest, however, that—except in 1972 when the ratio of funds supplied by the public sector fell sharply (in an election year!)—fiscal and monetary authorities made no attempt to offset changes in credit induced by net foreign flows.

Ratios of credit to GNP also serve as a rough indication of the relative tightness of credit conditions. There was a sharp decline in the share of funds raised by private domestic borrowers to GNP after 1979. The ratio of funds raised by this sector in 1981 is larger than the ratios in 1970 and 1975 but smaller than in any other year since 1969. This suggests that credit conditions were relatively tight in 1981 compared with 1969 and 1974 which were also years characterized by (then) historically high interest rates. In 1969 and 1974, however, both the U.S. government and the foreign sector were net lenders in U.S. credit markets in roughly equal amounts, and the share of funds supplied by the U.S. private sector was smaller than the share it borrowed. The reverse was true in 1981: both the government and the foreign sector were net borrowers and more funds were supplied than raised by the domestic private sector.

The ratios in Table 16 also show that foreign activity in U.S. credit markets since 1969 has been roughly comparable in scale to U.S. government activity in the years from 1969 through 1974. Foreign inflows as a share of GNP were slightly larger in the period 1969 through 1978 than the ratio of funds supplied to U.S. credit markets by U.S. government agencies and the Federal Reserve System over the same period, while the ratio of foreign borrowing to GNP from 1975 through 1981 was comparable to U.S. government borrowing in the period 1965 through 1974. Although government borrowing has been significantly larger than foreign borrowing in most years since 1974, the ratio of funds raised by foreigners to GNP in 1978 was the same as the ratio of government borrowing in 1979. Thus if the scale of U.S. government borrowing is viewed as an important factor in determining the amount of credit available to the U.S. private sector, recognition of the role that the foreign sector has played in influencing credit flows is long overdue.

Appendix C: Initiatives of the Subcommittee on Telecommunications, Consumer Protection and Finance

The major focus of legislative proposals and the debate on restructuring has been on the banking industry. This is necessarily the case because, given the special role of banks in the financial system banking law has tended to be the primary vehicle for structural definition.[1] But structural changes—both those that involve banks and bank products and services and those that do not—have a significant impact on other intermediaries and asset markets as well. The Subcommittee on Telecommunications, Consumer Protection and Finance has attempted to examine the impact of restructuring on securities markets because of its particular jurisdictional responsibilities and because of the importance of these markets for capital formation and economic growth. In addition, it has attempted to explore the underlying rationale for the current structural and regulatory framework and the ways in which actual and prospective changes in structure and regulation may affect traditional regulatory goals.

Subcommittee hearings: 1981-1983

In the period 1981 through 1983, the Subcommittee held seven hearings on these issues. The first hearings—on June 17 and 18, 1981—focused on the economic implications of changes in the securities industry[2] and heard testimony from regulators, larger New York-based firms and smaller, regional companies, representatives of major exchanges, academics and lawyers with extensive securities experience.[3] Discussions of developments in securities markets included such topics as the pressures for consolidation and/or diversification and the trend toward concentration within the industry; the impact of technological change and the growing internationalization and institutionalization of markets; the influence of tax policy on investment; the appropriateness of current regulatory strategies; the role of smaller regional firms in promoting initial public offerings, and the advantages and disadvantages of expanding investor protection.

These hearings also explicitly addressed issues related to financial restructuring, including views on the differences in functions and risks of different intermediaries and markets; the advantages and disadvantages of the homogenization of financial services; the wisdom of altering Glass-Steagall prohibitions on combinations of securities and banking activities, and the advantages and disadvantages of permitting combinations of securities and insurances activities or mergers between these intermediaries. Many of the witnesses stressed the need to examine the basic rationale for laws and regulations and to proceed slowly in making changes because of the need to preserve fundamental objectives such as investor protection and the underlying mission of the securities industry in promoting capital formation. There was also some agreement on the need to pay attention to fundamental structure and the effects of regulation on structure. One witness summed up these views as suggesting that a consensus on basic objectives was required as a framework for making change. His own view was that such a consensus had not yet been developed.[4]

---

[1] As discussed, banks have special responsibilities as conduits for monetary policy and providers of liquidity for other financial institutions and the economy as a whole—a role that is now shared by other depository institutions to some extent as well. Recognition of the special role of deposits as transaction balances and liquid savings assets provides justification for the provision of a public safety net which is only available as backing for this financial instrument. In addition, banks have unique market power in competing with other financial intermediaries because of their ability to tie sources and uses of funds.

[2] *The Securities Industry: Economic Implications for the Future*, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 97th Congress, 1st Session, June 17 and 18, 1981.

[3] The witnesses were: Walter E. Auch, Chairman, Chicago Board Options Exchange; James L. Bayless, President, Rauscher Pierce Refsnes, Inc.; Robert C. Clark, Harvard Law School; Jeffrey D. Davis, Acting Director of the Directorate of Economic and Policy Analysis, Securities and Exchange Commission; Ralph Ferrara, General Counsel, Securities and Exchange Commission; John A. Fitzgerald, Vice President and Director of Corporate Communications, Merrill Lynch & Co.; Stephen J. Friedman, New York, N.Y.; William R. Hambrecht, General Partner, Hambrecht & Quist; Robert M. Loeffler, Los Angeles, Calif.; Gordon S. Macklin, President, National Association of Securities Dealers, Inc.; Roger Mehle, Assistant Secretary for Domestic Finance, Department of the Treasury; Leland B. Paton, Senior Vice President, Bache Halsey Stuart Shields, Inc.; John J. Phelan, Jr., President and Chief Operating Officer, New York Stock Exchange, Inc.; Charles E. Rickershauser, Jr., Chairman, Pacific Stock Exchange, Inc.; Douglas Scarff, Director of the Division of Market Regulation, Securities and Exchange Commission; John S.R. Shad, Chairman, Securities and Exchange Commission. Additional statements were received for the record from: A.G. Edwards and Sons, Inc. and North American Securities Administrators Association, Inc.

These hearings were followed by extensive discussions with representatives of financial institutions, securities exchanges, regulatory bodies, businesses, consumer, labor, and legal groups, academics and others as a means to further explore issues raised in the initial hearings. They resulted in the introduction of a bill to create a Commission on Capital Markets and Capital Formation by Chairman Wirth with 70 cosponsors in August 1982. The Commission proposal was in response to the need to develop a consensus on the fundamental objectives of financial structure and regulation as a basis for decisions on restructuring, and reflected other, important concerns that are described below.

Hearings on long-term investment.—The 1981 hearings and subsequent discussions made clear that the availability and cost of long-term capital and credit had become a major concern affecting the growth prospects for the American economy. On April 14, 1983, the Subcommittee held a hearing on this issue,[5] receiving testimony from representatives of major financial institutions, basic and high technology industries, state and local governments and economists.[6]

Academic witnesses supplied data on the relationship between changes in financial and economic investment patterns. Much of the testimony and subsequent discussion focused on the macroeconomic environment as a major determinant of the shift from long- to short-term investment. Spokesmen from insurance companies—a major group of institutional investors that supply long-term capital—explained that rising rates of inflation and high and variable rates of interest had forced investors that had traditionally bought long-term, fixed rate issues to seek medium term, variable rate instruments. Their view—and that of a major securities firm instrumental in developing and marketing these issues—was that the emphasis on shorter maturities and variable rates would not impede capital formation.

But while the suppliers of capital thought current investment products were sufficient to meet the needs of users, the representatives of industry strongly disagreed. Their testimony provided compelling support for the view that investment in modernizing or expanding plant and equipment would not take place if current market conditions continued. Whether an older, basic industry, a small and innovative technology firm, or a large firm engaged in a highly competitive technology—all appeared to be experiencing similar problems in raising capital appropriate to their needs in terms of interest rate and maturity structure. These witnesses made the point that, in a globally competitive environment, the cost and availability of capital has become as important in determining competitiveness as wage rates. They provided evidence that U.S. companies are moving overseas—even into high wage countries—because of more favorable financing opportunities, raising concerns about jobs and the ability of the U.S. economy to benefit from its technological innovations.

State and local governmental witnesses expressed concern about the effects of a wider range of macroeconomic issues on their ability to finance their operations. While cut-backs in Federal assistance, tax revolts and a diminished tax base due to the recession had increased their demands for borrowed funds, Federal tax cuts and high interest rates had reduced investor interest in tax exempt issues and raised the cost of financing. But they also noted some significant changes in the market over the last decade, including a shift from general obligation bonds to revenue bonds and a shift from institutional to individual investors. Because of these shifts, they believe that permitting banks to underwrite revenue bonds would expand the market and increase the flow of funds to state and municipal governments.

---

[4] Testimony of Stephen J. Friedman, *The Securities Industry: Economic Implications for the Future*, *op. cit.*, p. 206.

[5] *The Future of Financial Markets*, Hearing before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Congress, 1st Session, April 14, 1983.

[6] The witnesses were: Gary P. Arnold, Vice President for Finance and General Financial Officer, National Semiconductor Corp.; Thomas H. Cooke, Jr., on behalf of Conference of Mayors; John G. Crosby, Managing Director, Merrill Lynch Capital Markets; Harry D. Garber, Senior Executive Vice President and Chief Financial Officer, Equitable Life Assurance Society of the United States; Donald D. Hester, Professor of Economics, University of Wisconsin; Malcolm T. Hopkins, Vice Chairman and Chief Financial Officer, St. Regis Paper Co.; Zoltan Kiss, President, Chronar Corp.; Raymond C. Scheppach, Executive Director, National Governors' Association; Francis H. Schott, Senior Vice President and Chief Economist, Equitable Life Assurance Society of the United States; Allen Sinai, Senior Vice President, Data Resources, Inc..

While the main focus was on these broader issues, the Subcommittee also engaged its witnesses in discussions of financial restructuring and other issues raised in the 1981 hearings.

Hearings on the FDIC securities proposal.—In hearings on June 16 and June 28, 1983 the Subcommittee focused on a specific regulatory change—the Federal Deposit Insurance Corporation's ruling that affiliates of insured state non-member banks are not subject to Glass-Steagall prohibitions against underwriting corporate securities, and its proposed ruling to impose limitations on the underwriting activities of these affiliates—with securities and banking regulators as witnesses.[7] Members of the Subcommittee present at these hearings, and members of the House Banking Committee invited to attend the June 28 hearing, expressed the view that such major structural changes should be decided by Congress rather than by regulators.

These hearings pointed up the fact that a significant number of trade-offs of objectives will be required in the process of consolidating financial services. There was general agreement among the participants that, given the special role of banks and substantial differences between banking and securities functions, permitting banks to underwrite corporate securities entailed a substantial degree of risk—that the FDIC's proposed rules were in themselves an admission of the fact that the hazards associated with bank involvement in securities activities do exist in varying degrees.

In addition to the focus on the differences in risk and managerial skills involved in banking and securities activities, there were extensive discussions of the history of banks' securities activities, the purposes of the Glass-Steagall Act and the background of developments leading to the exploration of the supposed "loophole" in the Act. Other discussions focused on the competitive effects of the proposed FDIC restrictions on banks' securities activities, their impact on profitability and soundness, and on banks special role in providing liquidity and as a transmission belt for monetary policy.

The primary focus of these hearings, however, was on the implications of bank entry into securities activities for securities markets. Some Members and witnesses expressed concern that a significant number of existing regional securities firms might be acquired by banks or forced out of business as a result of increased competition following bank entry into the activity, and that the effect of limiting banks' securities affiliates to underwriting investment grade corporate issues would be to contract markets served by regional securities firms.

Some also noted that the FDIC had focused its proposal on risk to banks at the expense of an equally valid concern for fair and equal access to capital and credit; that its restrictions could reduce the availability of one of the two options that small or new companies now have in forming special relationships with regional banks and securities firms; that larger, well established companies would not suffer from these restrictions; and that this could result in greater concentration in the financial services industry and lead to less, not more, competition.

The economic implications of changes in financial structure and regulation was the subject of the sixth hearing in this series, held on July 14, 1983.[8] Witnesses included a representative of consumer groups and an academic economist, both of whom have conducted extensive research on this subject; a major investment advisor and economist who participated in earlier discussions of financial restructuring as a member of the Hunt Commission, and a representative of a major securities firm.[9]

---

[7] *FDIC Securities Proposal and Related Issues*, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Congress, 1st Session, June 16 and 28, 1983. The witnesses were: E. Gerald Corrigan, President, Federal Reserve Bank of Minneapolis; William M. Isaac, Chairman, Federal Deposit Insurance Corporation; Bevis Longstreth, Commissioner, Securities and Exchange Commission; John S.R. Shad, Chairman, Securities and Exchange Commission; Lee Spencer, Director of Corporation Finance, Securities and Exchange Commission.

[8] *The Future of Financial Markets, op. cit.*, July 14, 1983.

[9] The witness were: Stephen Brobeck, Executive Director, Consumer Federation of America; Benjamin Friedman, Harvard University, Cambridge, Mass; Alan Greenspan, Chairman and President, Townsend-Greenspan & Co., Inc.; John C. Whitehead, Senior Partner, Goldman, Sachs & Co.

The central theme of the discussion was how financial structure and regulation impact on savings, investment and economic performance. Most witnesses agreed that macroeconomic policy is now the dominant influence affecting financial and economic stability. One witness took the view that "financial structure is not a key player in that game." [10] But the majority argued strongly that structural factors have—and will continue to have—an important role, and that other forms of government intervention in credit markets through such devices as the pension funding standards laid down under the ERISA legislation of 1974 and the tax code are also quantifiably important influences on savings and investment decisions and thus affect economic activity.

Other issues discussed in this hearing were the effects of short-term investment on corporate liquidity and the projected demand of the corporate sector for funds; the effect of higher interest levels in increasing loan demand and redistributing wealth; the impact of interest rate deregulation on the cost of credit; the diversion of credit resources into merger activities; and the impact of U.S. banks' foreign lending and of Third World debt problems on interest rates and liquidity in U.S. markets. In addition, the Subcommittee explored many issues related to financial restructuring that had been raised in earlier hearings, including the underlying reasons for differences in financial intermediaries' functions; the impact of deregulation on competition and concentration, and its impact on savers and investors.

Financial regulation from a state perspective.—The final hearing in this series was held by the Subcommittee in New York City on December 14, 1983.[11] The witnesses included state financial regulators and legislators and representatives of New York's major financial intermediaries.[12]

The purpose of this hearing was to explore the views and concerns of New York State authorities and industry spokesmen since New York law and regulation play a key role in determining the overall structure and regulation of the U.S. financial system. Much of the focus in New York has been on insurance—a major industry within the state and one for which it is the primary regulator in the nation. Like other states, this state has already made significant decisions about restructuring. But New York authorities have major concerns about the pace and direction of restructuring and actions by other states and at the Federal level. In the summer of 1983, the legislature created a Temporary Commission on Banking, Insurance and Financial Services to make recommendations on further legislative proposals and report its recommendations on February 15, 1984.[13]

The Commission was charged to take into consideration the need to maintain financial soundness by minimizing failure; to protect insureds, depositors, investors and other consumers of financial services, and to prevent conflicts of interest, fraud and concentration. It was also charged with a responsibility to relate changes in financial structure and regulation to the economic needs of the state and to establish a timetable for making changes that would minimize hardships for individual institutions.

Witnesses testifying before the Subcommittee addressed many of the goals which the Commission is seeking to embody in its recommendations. There was also discussion of the differences in the business objectives, risk and insurance guaranty programs that relate to specific financial functions; problems in insulating against risk; the treatment and monitoring of intra-firm transactions to prevent conflicts of interest, and the appropriate role for disclosure. Witnesses also discussed the potential for regulatory fragmentation as financial functions and products are blurred, with specific reference to the problems caused by sales of Baldwin-United single premium annuities outside New York [14] to New York residents and their implications for the state's insurance guaranty fund.

---

[10] Testimony of Alan Greenspan, *The Future of Financial Markets, op. cit.*, p. 253.

[11] *Financial Deregulation in New York State,* Hearing before the Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Congress, 1st Session, December 14, 1983.

[12] The witnesses were: Harold L. Lasher, Chairman, Committee on Insurance, New York State Assembly; James P. Corcoran, New York State Superintendent of Insurance; Vincent Tese, New York State Superintendent of Banks; R. Scott Greathead, Attorney-in-Chief, Public Advocacy Division, New York State Attorney General's Office; Richard H. Jenrette, Chairman and Chief Executive Officer, Donaldson, Lufkin & Jenrette Securities Corp.; Peter Herrick, President and Chief Executive Officer, The Bank of New York; John B. Carter, President and Chief Executive Officer, Equitable Life Assurance Society of the United States; Edward S. Cabot, Vice President and Associate General Counsel for Public Affairs, Equitable Life Assurance Society of the United States. Additional statements were submitted by Herman D. Farrell, Jr., Chairman, Assembly Banks Committee, New York State Assembly, and Clarence D. Rappleyea, Minority Leader, New York State Assembly.

[13] Although the primary recommendation of the Temporary Commission was that banks be allowed to engage in a wide range of insurance activities, there was considerable dissent among the Commissioners and the state assembly ignored this recommendation in adopting new legislation in July, 1984.

While deploring competitive actions by individual states such as South Dakota, most of the witnesses offered strong support for a continued role for states in financial regulation. They argued that state regulation adds diversity, flexibility, responsiveness and innovation to the overall regulatory framework. However, one industry spokesman suggested the need for some standardization of structure and regulation for insurance as well as other financial services under Federal authority.

Subcommittee hearings: 1984

The Subcommittee on Telecommunications, Consumer Protection and Finance resumed its hearings on financial restructuring in April and May, 1984, continuing its focus on the broad public policy issues, while examining the legislative options available to Congress to resolve immediate problems. The lead-off witness in this series of hearings was Paul A. Volcker, Chairman of the Federal Reserve Board.[15]

April 4 hearing.—Although Chairman Volcker addressed all the major issues in the current debate on financial restructuring, he gave priority to the urgent need for Congressional action to close the nonbank bank loophole. An immediate clarification of the legislative framework governing banking organizations was justified, he argued, by the rapid changes taking place in the financial services industry.

Mr. Volcker stressed the unhealthy aspect of recent developments. As new and changing activities are being forced into unnatural organizational forms by provisions of existing law and regulation, the original motivations and concerns embodied in these laws are being undermined. The restructuring process should seek to retain these broad public policy objectives. However, most changes are being initiated by financial institutions. Thus many of the public policy objectives and concerns are being ignored as market pressures and competitive interests assume a larger role. Rejecting the "level playing field" approach to financial restructuring, Mr. Volcker stated in his testimony that, ". . . competition alone cannot be relied upon to achieve the goals."

Depository institutions enjoy the special privilege of the safety net provided by the Federal Reserve and the FDIC, Mr. Volcker noted, and they, in turn, have special burdens and responsibilities that other nonfinancial institutions do not have. Banks, in other words, are special. To survive as institutions having the primary role in the payments system, banks must have the confidence of their customers. They must appear, and in reality be, sound institutions, for they contribute to the larger economic stability of our nation.

Mr. Volcker affirmed that the underlying public policy goals governing the structure and regulation of banks are the same as they were 50 years ago, when the regulatory system was established. However, the subordination of these goals to concerns about competition and market pressures is in part due to banks' need to increase earnings. And as other institutions move into traditional banking activities, banks feel they must in turn be allowed to participate in the activities of the "other" institutions. The guidelines clearly need to be reestablished, Mr. Volcker said, and urged Congress to take the initiative. Absent Congressional direction, the responsibility for shaping the evolution of the financial system will fall to others.

The Federal Reserve Chairman did not favor returning to the traditional, hard-fast lines separating banking and other financial functions. He believed that there were some natural extensions of related functions and activities in which banks should be able to participate. Mr. Volcker suggested that banks be allowed to underwrite municipal revenue bonds, establish and distribute mutual funds, participate in underwriting real estate insurance and offer travel products and services. Activities in which the Federal Reserve Chairman believes banks should not be involved are: corporate securities underwriting, some forms of real estate development and taking significant equity positions in unrelated nonfinancial activities.

By the same token, Mr. Volcker stated his belief that the core banking business should be conducted only by banks. Mr. Wirth, the Chairman of the Subcommittee, outlined a scenario using Sears as an example of a one-stop, all-needs-filled financial supermarket to illustrate his concerns about the melding of commercial and non-banking financial functions and the potential impact of the increased incidence of conflicts of interest and concentration outside the banking system on the impartiality of the credit decision process. Mr. Volcker responded: "We don't want Sears Roebuck in the banking business . . . and we don't want them in a general purpose thrift business operating in tandem in the manner that you described, with their commercial business, with their underwriting business, with their insurance business." [16]

---

[14] Restrictions on intra-firm transactions in New York law would have subjected Baldwin's investment strategies to scrutiny by state regulators. Baldwin elected not to sell its annuities in New York. State insurance regulators consider annuities an insurance product. The spokesman for the Attorney General of the State of New York (who has responsibility for state regulation of securities) took the view that annuities are more appropriately defined as securities.

[15] *Financial Restructuring: The Road Ahead"*, Hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 98th Congress, 2nd Session, April 4, 1984, Serial No. 98-144.

In his testimony and in his response to questioning, Mr. Volcker supported the Senate bill, S. 2181, as a foundation for addressing the problems facing the financial system. He stressed the need to clarify the definition of a bank and of a qualified thrift, close the Glass-Steagall and South Dakota loopholes and expand the powers of bank holding companies to include underwriting municipal revenue bonds and participation in real estate brokerage activities. In terms of loophole closing, Mr. Volcker agreed that the Subcommittee bill, H.R. 5342, would accomplish the same objectives as the Senate bill in terms of its effects on banks and thrifts. However, he believed a moratorium would be less desirable than permanent legislation, and that, by raising public policy issues outside the banking system, H.R. 5342 could impede efforts to defend established public policy in the depository institutions area.[17]

Mr. Volcker faulted the Senate bill for its lack of attention to interstate banking and Federal deposit insurance issues and encouraged Congress to set national policy in areas where it finds a compelling need to do so and then prohibit states from making different judgements. He criticized the haphazard approach of states, noting that they had become increasingly more permissive with their financial institutions simply to attract more jobs in the financial sector and more funding for their economies. In such an environment, Congress would have to assume responsibility for developing sound national policy.

The underlying theme in Chairman Volcker's testimony was the urgency of the need for Congressional action in restructuring the financial system. He did not support the Capital Markets Commission proposal advocated by Chairman Wirth because he saw it as delaying legislative action. In summary, Mr. Volcker stated: "I believe there is a wide area of conceptual consensus, and agreement on a critical core of legislation—on the definition of a bank and a qualified thrift and on regulatory simplification . . . The remaining issues surrounding the particular powers of a bank holding company are inevitably more controversial, but nonetheless ready for decision. We should not confuse lack of agreement among affected industry interests with the absence of necessary information and argumentation." [18]

At this time, hearings had been held on S. 2181, the Garn bill, and the Telecommunications and Finance Subcommittee had introduced H.R. 5342 the previous day. But the House Banking Committee had not yet introduced its bill. Mr. Volcker suspected the House would not accept the expanded banking powers the Senate advocated in their bill, but he felt there was enough time remaining in the session to reach a compromise. Minimally, the legislators should be able to pass the core legislation—defining a bank, a qualified thrift and providing some regulatory simplification.

April 5 hearing.—The Subcommittee on Telecommunications, Consumer Protection and Finance resumed its hearings the following day, with testimony from a panel of witnesses representing financial institutions and a panel representing consumer and labor organizations.[19] All but one of the witnesses on these two panels supported the Capital Markets Commission and Moratorium bill (H.R. 5342) that Mr. Wirth had introduced two days earlier. The representative of the American Bankers Association, Mark Olson, was the single exception. Like Chairman Volcker, he expressed concern that a moratorium would only serve to delay legislation.

The theme of Mr. Olson's testimony was that banks needed expanded powers and their claims were justified by the need to equalize competitive opportunity. Mr.

---

[16] *Ibid.*, p. 165.

[17] *Ibid.*, p. 168.

[18] *Ibid.*, p. 94.

[19] *Ibid.*, Witnesses on April 5, 1984 included: Richard H. Jenrette, Securities Industry Association; David Silver, Investment Company Institute; Richard S. Schweiker, American Council of Life Insurance; Leonard Shane, Mercury Savings & Loan Association; Jack King, Valley Bank of Kalispell; Mark W. Olson, Securities State Bank; Gale Cincotta, National Training Center; David L. Ratner, University of San Francisco School of Law; Henry B. Schechter, Department of Economic Research, AFL-CIO; Glenn Nishimura, Consumer Federation of America; James M. Hacking, American Association of Retired Persons.

Olson stated his industry's view that: "Under American capitalism fair competition leads to reduced prices, improved quality, and better service to consumers. It has always worked that way and we believe that it can work that way again in the financial services industry." [20] But, he added, the banking industry had been invaded by "those other" industries—insurance, giant securities firms, and giant retailing conglomerates—who had taken away a major portion of their market. Bankers feared their industry would decline if they were not allowed to compete on an equal basis. If, however, Congress failed to reach agreement on comprehensive legislation, the ABA suggested that it should at least force the side array of companies that own banks, but are not subject to the Bank Holding Company Act, to divest their banking activities immediately. Closing the nonbank bank loophole was, in fact, an immediate remedy on which all witnesses agreed.

Competition was viewed quite differently by other witnesses. Mr. Leonard Shane of the U.S. League of Savings Institutions argued that: "Unbridled market place competition does not automatically deliver needed financial services safely and efficiently to the public. It is the role of government to establish some order and assure that public policy purposes are met." [21] If our government is to continue to play a role in advocating financial public policy, he added, it needs to have tools to carry out this role. If banks want to be unregulated—to engage in the same activities as other financial services industries so that they can compete with them—they will cease to be "special" institutions. Once banks are permitted to do other business they will lose their uniqueness and no longer be able to justify enjoying the governmental safety net.

Mr. Jack King, representing the Independent Bankers Association, also supported expanded powers for banks, arguing that small banks, too, felt the need to compete and the need for new opportunities to expand their sources of income and profits. But he also supported the moratorium bill. Much of his testimony reflected his concern about the use of nonbank banks to erode restrictions against interstate banking. He justified his association's position by arguing in favor of using local deposits to meet local credit needs and preventing the concentration of local financial resources in a far-away institution not committed to the community. Mr. David Silver of the Investment Company Institute shared that concern, stressing the need to prevent the regionalization and concentration of power in the banking sector. Mr. Richard Schweiker, from the American Council of Life Insurance, was also concerned with the consequences of interstate banking but his testimony focused primarily on the need for legislation to prevent South Dakota-type enabling statutes from undermining the ability of Congress to set national public policy.

The bankers' arguments in favor of expanding their powers were strongly rebutted by the representatives of other financial institutions. The Securities Industry Association, represented by Mr. Richard Jenrette, claimed that the impetus for expanding banks' powers came from the large money center banks seeking to dominate the financial services industry by forming conglomerate financial supermarkets. Mr. Jenrette added that if banks were to be allowed to perform new securities activities, they should at least be required to establish a separate affiliate for the purpose. Mr. Schweiker explained the reluctance of life insurers to see banks acquire additional powers: they would lose their uniqueness—the special powers, privileges and protections which have provided a successful structure for banks and for the public.

Mr. Jenrette discussed the historical separation of banking and commerce, pointing out how successfully this segregation of functions had worked in the past and that it could continue to do so in the future. Mr. Schweiker was strongly convinced that the combination of banking and other forms of commerce would pose a serious threat to the continued safety and soundness of the system. Banks would be taking on additional risks in areas with which they were unfamiliar, and added risks were the last thing banks needed at a time when they were facing a record number of failures. Moreover, he argued: "Those failures were principally the result of poor investment, unsound loans, particularly in the energy area, self-dealing and general mismanagement—not loss of market share to other financial service providers." [22] In his view, the record did not support the banks' argument that they had lost a large share of their market to the other financial industries and therefore must be granted expanded powers to compete fairly.

Much of the discussion involving this panel of witnesses had focused on the issue of competitive opportunity among financial intermediaries. In that debate, however,

---

[20] *Ibid.*, p. 313.

[21] *Ibid.*, p. 271.

[22] *Ibid.*, pp. 247-8.

Mr. Shane of the U.S. League of Savings Institutions pointed out that the real competitors in the competition for credit are not the financial institutions, but more accurately the users of credit. The ability of the individual borrowing for a home, for example, or the small businessman or the farmer to compete for credit with giant corporate entities must be taken into consideration in discussing the structure of the financial system. Should we expect these and other customers of financial institutions to compete on an equal basis? Can they? Do we truly want a "level playing field"?

The second panel at the April 5 hearing unanimously opposed the Treasury and Garn bills, particularly with respect to expanded powers for banks. Mr. Glenn Nishimura of the Consumer Federation of America and Mr. James Hacking, representing the American Association of Retired Persons, agreed with Mr. Schweiker that banks should not be given more freedom. Mr. Nishimura argued that the success of partial deregulation had been dubious. Mr. Hacking quoted studies showing that outstanding loans to five Latin-American countries exceed 150 percent of capital of the nine largest U.S. commercial banks and proposed that deposit insurance rates be restructured to reflect increased risk-taking. Given the large amounts of dollars leaving the country and never returning, these banks were raising the liability of the United States as lender of last resort.

Ms. Gale Cincotta of the National Training Center agreed: "As long as government remains a guarantor, regulation will remain a necessary fact of banking life." And she surmised that increasing levels of capital outflows meant that there would be less credit here for U.S. farmers, small businesses and homebuyers. "The American economy is a capitalistic economy. That means that only those with access to capital can really participate," Ms. Cincotta noted.[23]

Ms. Cincotta was particularly concerned that banks were increasingly interested in attracting the more affluent or "upscale" customers. Given the impact of interest rate deregulation on the cost of funds, this development could be seen as inevitable. There was obviously more profit to be made in the upper portion of the market.

Chairman Wirth observed that one of the traditional regulatory goals for the financial system was assuring that low and moderate income level individuals have as great a degree of access to financial institutions as do wealthy individuals—just as a regulatory goal for the communications industry was assuring that everyone have access to a telephone. Mr. Henry Schechter of the AFL-CIO responded by warning that our credit needs could not be prioritized according to these goals with market forces guiding the industry. Government regulation would be necessary to assure equal access to credit. Moreover, he added, deregulation of banks would make it more difficult for the Federal Reserve Board to conduct monetary policy.

Ms. Cincotta concurred in these views, noting that the substantial amount of deregulation already underway had caused a shift in flows of funds from banks and thrifts to megafinancial supermarkets. One of these megafinancial institutions—Shearson/American Express—refers to credit as a "privilege". Such a view clearly ignores the traditional goal of assuring that credit is available and affordable to all, she noted.

The second panel of witnesses shared the belief that the traditional goals governing the regulation of the financial system—balancing competition and soundness, the protection of investors, depositors and policy holders, fair and equal access to capital and credit, and the prevention of conflicts of interest and the concentration of financial resources—were still valid. The first panel had taken a different approach. They were more concerned with keeping the system as fair as possible from a competitive perspective. However, both panels agreed that the guidance of Congress was needed in restructuring the financial system and in addressing some of the immediate problems and loopholes. All witnesses noted that a substantial amount of restructuring had already occurred and that the process so far had tended to increase rather than resolve problems. Except for the representative of the American Bankers Association, all witnesses agreed that the moratorium proposed by Chairman Wirth would be beneficial. The ABA witness argued that the decline in banks' competitive position required immediate attention; that the issues had been studied and discussed and immediate deregulatory action was warranted.

May 17 hearing.—Shortly before the next hearing held by the Subcommittee on Telecommunications and Finance on May 17, the Comptroller of the Currency, C. Todd Conover, issued an ultimatum to Congress that greatly increased the pressure for legislative action. Although he extended his moratorium on approvals of nonbank banks to the end of the legislative session, he warned that if Congress had not acted by that time, he proposed to approve some 300 applications filed by larger banks to use the loophole in current law to evade restrictions on interstate banking.

---

[23] *Ibid.*, p. 418.

Chairman Wirth announced that this would be the last of the Subcommittee's hearings, noting that the time had come to move on financial restructuring legislation. The Capital Markets Commission and Moratorium bill, H.R. 5342, introduced April 3 embodied many concerns expressed during this series of hearings, which had raised the broader issues in the restructuring process and signalled to the Senate that expanding banks' securities powers had little support in the Energy and Commerce Committee.

Witnesses at the May 17 hearing represented the life insurance, securities and banking industries, as well as the Department of the Treasury.[24] The industry witnesses agreed that closing the nonbank bank loophole was the top priority for legislative action. Mr. Kenneth Guenther of the Independent Bankers Association of American predicted that if the nonbank bank scenario continued to be played out, we would soon have a separate, nonbank banking system parallel to the current banking system, operating throughout the U.S. without the consent of Congress.[25] These two systems would differ radically because the major exploiters of the nonbank bank loophole are so diverse. It is not simply a problem of one industry trying to get into banking. Loophole exploiters include securities firms, diversified financial industrial conglomerates, other financial services organizations, department stores, insurance companies, and retail companies. The Treasury witness, Mr. Thomas Healey, saw closing the nonbank bank loophole as a less urgent priority, consistent with his more favorable view of financial integration.

Commenting on the moratorium bill proposed by Chairman Wirth, Mr. Healey said that Treasury could not support it because it would only delay a much-needed legislative response to *de facto* financial restructuring. And, he added, a moratorium would be unfair, favoring those who were aggressive enough to enter the prohibited activities before the cut-off date. Mr. Guenther also opposed a moratorium on the grounds that events had passed that by as a viable alternative. Bankers, he said, were resolved to look toward a broader bill—one that included an expansion of banks' powers—and would only be interested in the moratorium approach if that did not emerge. Asserting that the securities industry was less afraid of competition than confusion, Mr. Linton gave loophole-closing top priority. But he saw a moratorium as a viable compromise that would help clarify who could do what, and therefore supported the bill.

The President of the Metropolitan Life Insurance Company, Mr. John Creedon, criticized H.R. 5342, the moratorium bill, as going too far. He approved of the provisions keeping banking from intermingling with other financial industries and with commerce, but objected to those that would keep the insurance industry from engaging in non-financial business. The insurance industry is not a major player in the financial arena, Mr. Creedon said, arguing that it is attracting less savings as a result of increased competition from money market funds and other investment opportunities. He discounted the Subcommittee Members' concerns about conflicts of interest arising as a result of the intermingling of insurance and commerce, asserting that state regulation had proved adequate in preventing abuse. Mr. Creedon saw the Wirth bill as a threat to state regulation of insurance. He maintained that the states have regulated the insurance industry for so long and done so well that there was no need to move insurance regulation to the Federal level.[26] Although New York State tended to have the strictest regulatory standards, other states often emulated them. The fact that some companies had chosen to diversify, hoping to gain a slight advantage, and used the loopholes in Federal law to enhance their competitiveness, was not related to the issue of state regulation.

Chairman Wirth agreed that the system had indeed worked well in the past, when insurance companies had been confined primarily to the insurance business. However, he predicted that, as in the case of the banking industry, there would soon be a gradual deregulation on the part of the states in an effort to compete. At this point, Chairman Wirth suspected, there would be a notable relaxation of restrictions against conflicts of interest.

The basic topics discussed at the hearing (closing the loopholes, the moratorium proposal, financial regulation) revolved around the issue of allowing banks to engage in securities or insurance or nonfinancial activities. The spokesmen for the securities and insurance industries opposed the entry of banks into their businesses on the grounds that the banking industry had a much greater capacity to overtake the other two than vice versa. Mr. Guenther of the IBAA countered with the assertion that anyone could buy money these days, but that banks, with their reserve requirements, could not compete fairly with other institutions. The representative of the Treasury Department, Mr. Healey, agreed that banks should be permitted to compete fairly. Once the "level playing field" had been achieved, competition would make the market more efficient. Listing the benefits of deregulation, Mr. Healey predicted there would be a wider variety of services, at lower prices, with convenient one-stop shopping.[27]

---

[24] *Ibid.* Witnesses at the May 17 hearing included: Thomas Healey, Department of the Treasury; John J. Creedon, Metropolitan Life Insurance Co.; Robert E. Linton, Drexel Burnham Lambert Inc.; Kenneth Guenther, Independent Bankers' Association of America.

[25] *Ibid.*, p. 614.

[26] It should be noted, however, that Congress retains an oversight role over insurance regulation under the McCarran-Ferguson Act.

Mr. Linton elaborated on his reasons for opposing bank entry into the securities industry: increased concentration of financial power, unfair advantage, tie-ins, and risk.[28] He contrasted the soundness of the securities industry with the fragility of the banking industry, arguing that securities regulations requiring that firms constantly value their assets at current market value ("mark to market") had contributed to the strength of securities firms. Although securities is an inherently risky business, securities firms risk their own money. The nature of banking demands that depositors get back the money they deposit, with minimum risk. Enough risk had been taken by banks in their lending activities, Mr. Linton argued, that they should not be allowed to take on the added risk of securities activities. He dismissed the perception that securities firms are rushing into banking as being blown out of proportion. Only 1 percent of all U.S. deposits were held by nonbank banks, he asserted, and those owned by securities firms usually used an actual bank to clear for them; they only provided the intermediary service.

Mr. Creedon explained why he was reluctant to allow banks into the insurance business by citing banks' unique role in our financial system and the special privileges they enjoy. He argued that government must and should continue to be concerned about the solidity of banks. Because the business of banking directly affects national and international economies, the public policy concerns related to this industry should be preeminent. In Mr. Creedon's view insurance has no place in that scenario, but the public policy needs that created the barriers separating banking, insurance and securities years ago, still exist; no one has demonstrated that these traditional goals are no longer pertinent.

Mr. Creedon joined with Mr. Linton in cautioning against increasing the risk to banks given the increasing number of bank failures. He also argued against expanding the banks' insurance powers because of the increased potential for tie-ins and conflicts of interest. Banks have inherent credit leverage and a continual relationship with anyone who chooses to keep an account there, he noted. Corporations and individuals rely on banks. It would be difficult to keep this unique form of market power from coming into play when selling insurance. Mr. Creedon viewed the provisions of the Garn (Senate) bill addressing tie-ins as inadequate and Mr. Linton added that he doubted the legislation could be rephrased to adequately handle the problem. The conclusion seemed to be that prohibiting the consolidation of banking with insurance and securities activities had been successful in addressing the problem in the past and should be retained.

Putting aside further discussion of which financial industry should be involved in others' traditional turf, all industry witnesses agreed that Congress should be taking the lead. Mr. Guenther asserted that the present situation found "non-regulator regulators" making the decisions that should be made by Congress [29] He also cautioned that when the Chairman of the Federal Reserve Board warned that the haphazard exploitation of loopholes jeopardizes the safety and soundness of the banking system—as Mr Volcker did before the Subcommittee on April 4, 1984—it should not be taken lightly.[30] And Mr. Creedon pointed out that before doing away with the current regulatory structure, Congress should have a substitute one to replace it. While adding the caveat that, "Not even the Congress of the United States can legislate good management or good judgement," he expressed the consensus view that Congress must decide the direction for change.

Mr. Healey of the Treasury Department concurred in the view that government should reestablish order in the financial system. He lamented that without the necessary changes, money will flow to people who can use it and who can afford to pay for it. In response, Congressman Tauke summed up the Subcommittee's perspective on the issue of restructuring:

---

[27] *Ibid.*, p. 542.
[28] *Ibid.*, p. 594.
[29] *Ibid.*, p. 613.
[30] *Ibid.*, p. 615.

> What I think we are trying to do is assess what kind of impact the structure of these financial institutions and the structure of this regulatory scheme will have on the flow of capital to consumers and what impact does it have on the stability of our economy as a whole. That is the larger question.[31]

Summary of activities in 1985

The Subcommittee on Telecommunications, Consumer Protection and Finance resumed its consideration of issues related to financial restructuring early in the 99th Congress. Given an increase in membership from 16 to 25, Chairman Wirth arranged a Subcommittee trip to New York on February 11 and 12, to brief Members on the finance agenda before the Subcommittee. Financial restructuring was discussed at a meeting with Dr. Henry Kaufman, Executive Director, Salomon Brothers, Inc.; with officers of the New York Stock Exchange; with the chief executive officers of the major New York securities firms; and, with the heads of major New York banks.[32]

The Subcommittee's 1985 hearing agenda was organized to address the unexplored issues in financial restructuring—conflicts of interest, the internationalization of capital and credit markets, securitized credit, derivative instruments, leveraging and the erosion of credit quality and financial stability—with a continued focus on the broad public policy issues. Material from these hearings, together with statements from the earlier hearings, has been used to augment the discussion in Part II of this report which examines the impact and implications of restructuring on traditional regulatory goals.

April 2 hearing.—The Subcommittee on Telecommunications, Consumer Protection and Finance opened its financial restructuring hearings for the 99th Congress with a focus on how the growing trend toward consolidating financial functions and products affects the way financial institutions make capital and credit decisions. Testimony from a panel of regulators and a panel of industry witnesses laid the groundwork for the first hearing.[33]

SEC Commissioner Cox strongly advocated functional regulation, predicting that it would provide the much-needed uniformity currently lacking in the regulatory system. In his view, the Subcommittee's concerns about conflicts of interest could be addressed through increased disclosure for financial institutions and by requiring that financial institutions holding companies be organized with a separate subsidiary for each different function.

Federal Reserve Governor Partee voiced concerns very similar to those of the Subcommittee:

> Our concerns have been to ensure impartial access to credit, promote efficiency in the provision of financial services, limit undue concentrations of resources, minimize potential conflicts of interest, and preserve a strong and stable banking system.[34]

He agreed with Commissioner Cox that if securities, insurance, banking and real estate activities were to be permitted within one company, they should be carried out in separate subsidiaries, but urged continued separation of banking and commerce within the holding company structure.

Mr. Raiden noted that a primary concern of the FHLBB was the precarious situation of so many thrifts and thus, necessarily, of the FSLIC. With respect to financial consolidation, however, he said:

---

[31] *Ibid.*, p. 564

[32] Other discussions were held with securities lawyers and corporate executives on the Subcommittee's agenda on corporate mergers and takeovers.

[33] *Financial Consolidation: The Emerging Regulatory Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, April 2, 1985. Witnesses included: Commissioner Charles C. Cox, Securities and Exchange Commission; Governor J. Charles Partee, Federal Reserve Board; Mr. Norman Raiden, General Counsel, Federal Home Loan Bank Board; Mr. Leonard Shane, Chairman, Mercury Savings and Loan Association; Mr. John L. Steffens, Senior Vice President, Merrill Lynch and Company, Inc.; Mr. Phillip M. Knox, Jr., Vice President, Sears Roebuck and Co.; Mr. Paul S. Applegarth, Senior Vice President, Bank of America; Mr. Harry L. Freeman, Executive Vice President and Mr. Hugh H. Smith, Senior Vice President, American Express Co.

[34] *Ibid.*, p. 18.

> We have had [a policy of separation] but through a series of loopholes and evolvement of activities, all of those functions are now being blended. And if there is to be any separation, certainly the Congress is going to have to do something about it.[35]

In his view, having the regulators make these decisions would probably lead to piecemeal, inconsistent policy.

In questioning the regulators, Members of the Subcommittee indicated they were not convinced that functional regulation and separate subsidiaries would sufficiently protect the traditional public policy goals for the financial system. They perceived a potentially large gap in the regulation of activities *between* subsidiaries (or affiliates) that would not be covered under functional regulation. Congressman Nielson, in pointing out that disclosure would not be sufficient, said:

> I think there have to be prohibitions and limitations on transfers among the components of a financial holding company in order to avoid conflicts of interest and the weakening of the parts of the structure.[36]

The lead-off witness on the industry panel—Mr. Steffens, testifying on behalf of Merrill Lynch—strongly advocated functional regulation, deregulation and competition: "If competition forces some of the less efficient providers out of those aspects of the business, we believe that ultimately this is a healthy result."[37] Similarly, Mr. Applegarth from Bank of America called for increased competition, disclosure and financial innovations. He also resurrected the often-used phrase "level playing field" in describing what his institution thought was necessary to ensure efficient money and capital markets, a stable payments system and protection for the consumer.

In response to the Members' concerns about conflicts of interest, concentration and tie-ins, Mr. Freeman, representing American Express Co., expressed the view that the current regulatory structure and market forces provide adequate safeguards. He acknowledged that, increasingly, financial (and some commercial) institutions fail to fulfill their original purposes, and are engaging in turf battles.[38] But Mr. Freeman reiterated the claim that adaptations made by the financial industry were to benefit the consumer.

Each witness on the industry panel, except for Mr. Shane of the U.S. League of Savings Institutions, continually referred to the consumers' wishes, demands and benefits as the driving force behind increased consolidation of financial functions. All new activities the institutions proposed were justified as being in the consumers' interest. Mr. Shane took exception, being:

> Very, very strongly opposed to the concept that we are moving inexorably towards homogenization of all financial institutions, that we are moving inexorably into some sort of a free market which requires giving regulators horrendous powers, if you please, and that we are moving into some sort of a market situation where disclosure is equated with fair practices.[39]

Mr. Knox, the representative from Sears, took exception to the fact that his institution was continually used as a negative example. He explained that Sears was not new to the financial industry, having offered credit to farm families as far back as 1911 and having organized the Allstate Insurance Company in 1931.[40] Like his fellow panelists, Mr. Knox foresaw no potential problems arising from conflicts of interest in having a real estate firm, savings and loan, and department store all within one institution. Separate subsidiaries with separate managers would provide the necessary independence and safeguards.

Subcommittee Chairman Wirth remained unconvinced that the activities and relationships *between* subsidiaries (or affiliates or functions) could be adequately monitored. To address these issues he asked the witnesses to consider a financial institutions holding company structure that would be modeled after the Public Utilities Holding Company Act (PUCHA) in the sense that a single regulator would have responsibility for monitoring intracompany financial transactions within an integrated financial conglomerate. Without a more specific description of such a structure, witnesses were hesitant to comment, but most were not receptive. Governor Partee and Mr. Raiden, however, thought the concept should be explored.

---

[35] *Ibid.*, p. 40.

[36] *Ibid.*, p. 33 of hearing transcript.

[37] *Ibid.*, p. 77.

[38] *Ibid.*, p. 117.

[39] *Ibid.*, p. 63.

[40] *Ibid.*, p. 78.

May 2 hearing.—Continuing its examination of how changes in financial structure affect the economy and the existing regulatory framework, the Subcommittee on Telecommunications, Consumer Protection and Finance held a hearing on the policy implications of expanding securities markets. The most dramatic developments of the 1980s provided three themes around which the hearing was focused: the internationalization of capital markets, the growth of securitized credit and the proliferation of derivative instruments. This hearing was also structured with a panel of regulators and a second panel of industry representatives.[41]

SEC Chairman Shad outlined various steps the Commission had taken to ensure U.S. investor protection in light of the increasing internationalization of the markets and noted that it had circulated two approaches for comment—one providing for reciprocal disclosure requirements and the other for the development of a common prospectus—which would meet basic U.S. criteria. Both Chairman Shad and Federal Reserve Vice-Chairman Martin linked the increased impetus for internationalization to the fact that the U.S. is importing far more capital than it's exporting. According to Vice-Chairman Martin, this was so because the borrowing cost for U.S. firms was generally cheaper in overseas markets.[42]

Vice-Chairman Martin noted that The Federal Reserve permits subsidiaries of U.S. banks abroad to engage in investment banking activities (which are forbidden to them in the U.S.) so they can more effectively compete with foreign banks. While he saw no problem with this, he did, however, state his belief that every major technological advance in financial services is accompanied by a degree of risk and that, therefore, the growing internationalization of the marketplace requires a much wider, deeper examination process. Mr. Maxwell's perspective on the internationalization of the capital markets was more closely related to his industry's expectation that it would reduce domestic housing costs.

Subcommittee Chairman Wirth, and Mr. Rinaldo, the ranking minority Member, were concerned that investor protection in the United States could suffer as competition between U.S. and foreign securities markets increased. They noted that pressure on U.S. markets to deregulate might lead to inadequate protection by U.S. standards.

Mr. Friedman, of Debevoise and Plimpton, was the only witness on the industry panel who agreed that the internationalization phenomena was accompanied by some threat to investor protection. He believed other countries with significantly lower regulatory standards posed serious problems for market surveillance, international enforcement and tender offer regulation. The current system, Mr. Friedman observed, allowed things to fall between the cracks of a broadening marketplace[43] because the markets had evolved far beyond the old regulatory system. With growth in the amount of trading between major market centers, new mechanisms and a greater degree of cooperation were needed to adequately address the regulatory challenge.[44]

Mr. Batten, representing The First Boston Corporation, stated that internationalization of the securities markets was good for capital formation, in that it broadens the capital markets and makes them more fluid. Responding to the Members' concern that standards would be lowered or compromised, he pointed out that the Bank of England was in the process of tightening its capital requirements. Mr. Mendoza of Morgan Guaranty Trust Company and Mr. Beim, from Bankers Trust Company, predicted that the harmonization resulting from increased internationalization would lead to higher foreign regulatory standards, not lower U.S. standards.[45]

Arguing that the free movement of capital between nations is extremely beneficial, Mr. Mendoza saw only beneficial effects emanating from internationalization. He suggested that allowing the U.S. banking system to compete in the Euromarket underwriting business would enable them to diversify their source of profits and he gave assurances that there was no evidence of conflicts of interest in the international markets. The one potential danger, he acknowledged, was that underwriting banks might be forced to absorb issues priced above secondary market yields, placing them in portfolio.[46] In summary, Mr. Mendoza argued for a response to expanding internationalization that would involve rationalizing the regulatory process to include a combination of regulation and market discipline.

---

[41] *The Expanding Securities Markets: Regulatory and Economic Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, Serial No. 99-21, May 2, 1985. Witnesses included: Honorable John S.R. Shad, Chairman, Securities and Exchange Commission; Honorable Preston Martin, Vice Chairman, Federal Reserve Board; Mr. David O. Maxwell, Chairman, Federal National Mortgage Association; Mr. Roberto Mendoza, Executive Vice President, Morgan Guaranty Trust Company; Mr. David Batten, Managing Director, The First Boston Corporation; Mr. David O. Beim, Executive Vice President, Bankers Trust Company; and Mr. Stephen J. Friedman, Debevoise and Plimpton.

[42] *Ibid.*, p. 228.

[43] *Ibid.*, p. 339.

[44] *Ibid.*, p. 317.

[45] *Ibid.*, p. 334.

The securitization of credit was the second major area of focus for the hearing and one on which each witness commented favorably. SEC Chairman Shad noted that the securitization process permits individuals and institutions to earn the best possible returns on investments, and permits banks to free up their capital. Vice-Chairman Martin outlined ways in which securitized loans help investors diversify their risk but noted that recent problems (such as those Bank of America encountered) did point out some inherent dangers. He suggested that efforts to reduce risk would need to focus on two key areas: loan evaluation and insurance of the ultimate product.

Chairman Maxwell of Fannie Mae took the view that Bank of America's $95 million mortgage-backed security loss was an aberration and not an accurate picture of what to expect as securitization gains momentum. He pointed out that most of the loans were nonexistent and a very questionable insurer was used in that instance. Chairman Maxwell highlighted his agency's involvement in a study of recommendations for a National Mortgage Exchange to facilitate trading in the secondary mortgage market. He anticipated the need for a centralized trading structure based on the enormous growth in trading and recent technological innovations. The enhanced competition and efficiency that would be derived from such an exchange would benefit homebuyers, lenders, dealers and investors.

First Boston's witness, Mr. Batten, listed the advantages of securitization: it allows for the sale of assets, frees equity capital and provides new sources of funds.[47] His comment on the issue of safeguards for mortgage-backed securities was that the responsibility rests on the sponsors of the securities in doing due diligence, and that was lacking in the Bank of America episode. Mr. Batten and Mr. Friedman, of Debevoise and Plimpton, agreed that the majority of mortgage-backed securities are very safe because they are ultimately backed by the full faith and credit of the U.S. Government. Mr. Beim from Bankers Trust, in reiterating the benefits of the securitization of assets stated that the ability of banks to sell their loans improves liquidity which, in turn, contributes to soundness. In response to a concern raised by Congressman Nielson, Mr. Batten assured him that securitized assets do not crowd corporate issues out of the market.

The final major topic covered at the hearing was the proliferation of derivative instruments such as options, futures, options on futures, stock index options and futures, and interest rate swaps. Chairman Shad's position was that these innovative instruments enhance the liquidity of the underlying cash markets, expand opportunities for hedging and therefore reduce risk. Vice Chairman Martin concurred in that view of their value in shifting risk, adding that there was simply not enough evidence to conclude that derivative instruments have a negative impact on capital formation.[48]

In response to Members' concern about the increase in speculative activity associated with derivative instruments, Mr. Mendoza of Morgan Guaranty pointed out that it was necessary for one party to assume a speculative role—otherwise everyone would always choose to be on the same side of the deal. He listed the benefits of derivative instruments as: efficiency, liquidity and hedging. Along the same lines, Mr. Beim hailed the protection against risk that derivative instruments afford,[49] asserting that banks that utilized the available new instruments were sounder than thrifts.

Mr. Friedman acknowledged that there was an increase in speculation associated with options but noted that there was a low level of complaints to the SEC related to options trading and therefore no real cause for concern. In response to the Members' concern about the precipitous growth in derivative instruments and the accompanying risk, Mr. Friedman pointed out that they were a response to increased risk; that any institution holding fixed income securities, such as government securities, in its portfolio is subject to substantial risk because interest rates are so volatile. Banning derivative instruments, he maintained, would not help. Addressing the

---

[46] *Ibid.*, pp. 280-281.

[47] *Ibid.*, p. 293.

[48] *Ibid.*, p. 229.

[49] *Ibid.*, p. 331.

Subcommittee's long-standing concerns for capital formation, Mr. Friedman argued that derivative instruments were useful in providing depth and liquidity to the market, thus facilitating its ability to fund capital formation.

Referring to the Subcommittee's previous hearing on financial consolidation and the emerging regulatory issues, Mr. Friedman offered the opinion that the initiative had, in essence, passed from Federal to state legislators. Unfortunately, he pointed out, the latter were more concerned with local business development than with the soundness of financial institutions.[50] Mr. Beim said he believed requiring that separate activities of large financial holding companies be carried out in separate subsidiaries would adequately address the Members' concerns about consolidation and conflicts of interest.

June 5 hearing.—The purpose of this hearing was to address the broader issues in the areas of financial restructuring and takeover activity in terms of national policy concerns with respect to capital formation, U.S. international competitiveness and the soundness of the financial system.

Dr. Henry Kaufman, Executive Director of Salomon Brothers, outlined the adverse credit developments that he believed were threatening the U.S. economy: (1) credit market debt was increasing at an unprecedented pace—faster than GNP; (2) short-term borrowing was rising rapidly, while long-term borrowing had diminished significantly; (3) the quality of credit was rapidly deteriorating, exacerbated by merger and acquisition trends; (4) institutional asset quality was declining and the equity base of many financial institutions was exceedingly thin.[51] Credit, in Dr. Kaufman's view had no guardian. The link between creditors and borrowers was diminishing and, in some cases, nonexistent, due to in part the proliferation of floating rate financing and securitized credit obligations.

Subcommittee Chairman Wirth was particularly concerned about the $100 billion of corporate equity that had been retired for debt, mostly through mergers and acquisitions, during the previous year. In response to that concern, Dr. Kaufman proposed that all assets be written down to liquidation value to discourage investment in "junk" bonds and curb the trend.

Professor Robert Clark of the Harvard Law School discounted that concern. He argued that the rise in debt (or leveraging) in our economy due to tender offers was small because not that many companies were involved in takeovers each year.[52] His suggestion was to change the tax laws to eliminate the discrepancy between the treatment of debt and equity so there would be less incentive to over-leverage. He added that the Government should not bail out failed industrial firms, and that the market should price risky debt at higher interest rates. In Professor Clark's view, the problem of over-leveraging should not be used as a justification for hindering the takeover process.

Dr. Kaufman argued that for financial intermediation to work, financial institutions must be perceived to merit public trust and must preserve the integrity of credit. This could be done in two ways: through market forces (allowing institutions to fail and/or prosper) and through close official supervision and/or regulation. All three witnesses and Chairman Wirth agreed that market forces alone could not assure financial stability. Based on this assumption, Dr. Kaufman offered several proposals.[53] He advocated centralizing the regulatory process by establishing a National Board of Overseers of financial institutions and a similar board at the multinational level; higher regulatory standards, better regulators and therefore higher salaries for regulators; more disclosure; higher capital requirements;[54] the valuation of financial assets on a liquidation basis rather than a regulatory accounting basis, and the formation of a credit rating system.

Dr. Kaufman also stressed the importance of reducing the huge budget deficit to make these other measures more effective. Reducing the deficit would result in the Government's requiring less long-term, fixed-rate financing, which would encourage individuals and institutions to invest in long-term private assets. The growth in private short-term debt troubled Members of the Subcommittee and Dr. Kaufman agreed that this was detrimental to the nation's economic goals.[55]

---

[50] *Ibid.*, p. 316.

[51] *Financial Restructuring and Takeover Activity: The Major Policy Issues*, Hearing before the Subcommittee on Telecommunications, Consumer Protection and Finance, Committee on Energy and Commerce, U.S. House of Representatives, 99th Cong. 1st Sess., Serial No. 99-21, June 5, 1985, pp. 377-378.

[52] *Ibid.*, p. 419.

[53] *Ibid.*, pp. 380-382.

[54] Professor Clark disagreed, stating that there was no evidence that higher capital requirements would prevent failure.

[55] *Ibid.*, p. 378.

In Dr. Kaufman's view, government has a responsibility to provide mechanisms that moderate extreme swings within the financial system because such extremes create greater financial vulnerability for households and businesses.[56] Financial institutions differ from other entities, he maintained; they have a public responsibility because they hold the savings and temporary funds generated by the U.S. economy and provide a link between the economies of the U.S. and the rest of the world.

Former SEC Commissioner Longstreth agreed that financial institutions have a unique role. And he pointed out that, given the growing interdependence and fragility within the industry, the difficulties of one institution can threaten a chain reaction extending well beyond the companies directly involved. In Mr. Longstreth's view, market discipline would only ensure soundness if institutions were permitted to fail. But linkages among financial intermediaries were too extensive, strong and numerous to prevent one failure from triggering others. Therefore, failure and its consequences was unacceptable and a new system of direct regulation to assure soundness was needed.

Professor Clark focused on the concept of "letting an institution fail". He said that when the value of its assets is less than its liabilities, an institution has failed. Thus the issue is the protection of uninsured depositors, shareholders and employees. The relevant question, according to Professor Clark, is what to do after the failure. The current options are bankruptcy proceedings or acquisition by another entity.

Congressman Swift raised concerns about the economic implications of protecting only large banks. Since the repercussions of failure seemed too great to allow, such a policy would tend to lead to a monopoly. Some government regulation would be necessary, he surmised.[57] Dr. Kaufman agreed and reiterated the need for more discipline for large institutions so they could be held accountable. This could be accomplished by a more realistic pricing of assets, a higher capital base, increased disclosure and other recommendations he had previously outlined.

Professor Clark introduced a different perspective. He described the financial institutions conglomeration and expansion process as one still gaining momentum, eroding geographic barriers within and across nations, and resulting in different kinds of institutions combining in holding companies. Factors responsible for this trend were: (1) the technological changes in communications and data processing which facilitated the linkage of markets of all sorts and permitted efficient combinations not possible before, and (2) consumer and financial institutions' preferences. If channeled correctly, the trend toward a diversified system would lead to greater safety and soundness, he argued. Therefore, he advocated increased powers for banking institutions, such as underwriting revenue bonds and sponsoring mutual funds.

Acknowledging the expansionist mode of the financial services industry, Congressman Slattery raised the issue of size. How big do we want our financial institutions to become? Would we be comfortable entrusting the financial security and stability of this nation to the boards of directors of two major financial conglomerates?[58] This would leave the margin for error strikingly small. Narrowing his focus, Mr. Slattery questioned how we could assure that vital, slow-growth sectors are adequately capitalized, in light of the deregulatory trends. He was concerned for farmers having to compete with major money centers for a shrinking pool of capital. In response to the latter concerns, Dr. Kaufman predicted that the federal farm credit agencies would need to undergo a major restructuring.

In addition to the size issue, other problems associated with financial deregulation and restructuring were discussed. Mr. Longstreth observed that, as banking and commerce became increasingly intertwined, it was more and more difficult to save only a bank when a holding company structure went down. Therefore, the creditors of the holding company would benefit from the same protection meant for the depository institution. The premise behind the Treasury proposal to allow banks to enter new activities was that segregating different activities in separate subsidiaries would provide safeguards and promote independence. Mr. Longstreth believed this view overlooked the realities of business; that it was unlikely that various corporations within the holding company would be sufficiently independent to survive the collapse of affiliates. He pointed out that even Federal Reserve Chairman Volcker agreed that banks cannot be wholly separated from the fortunes and failures of affiliates' business objectives.[59] Mr. Longstreth's concluding thought was that the

---

[56] *Ibid.*, pp. 442-443.

[57] *Ibid.*, p. 446.

[58] *Ibid.*, pp. 465-466.

[59] *Ibid.*, p. 401.

AVAILABLE

present regulatory system lacked a coherent structure—too much was left to chance.

Dr. Kaufman concurred; separate activities in separate subsidiaries would not yield isolation and independence. He noted that the ultimate strength of subsidiaries depends on the capital of their holding company. The level playing field that some of the financial industries were calling for could not be achieved under this structure, Dr. Kaufman said, because a bank holding company, as opposed to any other holding company, would have the benefits of deposit insurance and access to the Fed window. Avoiding conflicts of interest was an additional issue that, in his view, needed to be addressed. When institutions act as a lender, an equity investor and an underwriter—all within a single conglomerate—there are bound to be inequitable compromises.

Professor Clark agreed that regulation of self-dealing and conflicts of interest was crucial in a holding company structure. Necessary elements of this would be the careful and accurate measuring, controlling and pricing of risk. As the combinations of activities within holding company systems increase, he predicted, the level of self-dealing and conflicts of interest would also rise. The need for stricter rules would then be even stronger.

APPENDIX D: REFORMING THE FEDERAL DEPOSIT INSURANCE PROGRAMS

The ability of existing financial guaranty programs to provide adequate protection for customers has become a central issue in financial restructuring. Currently, the focus is on the insurance programs for thrifts (the FSLIC) and pension funds (the PBGC). But other developments—the threat posed by the Continental Illinois crisis, the impact of the failure of Baldwin-United on small savers, and the inability of State deposit insurance programs to cope successfully with crises in Ohio and Maryland—have made clear that the adequacy of the various funds in relation to perceptions of the level of risk is the key issue in maintaining public confidence in the financial system.

Existing provisions for insuring financial assets raise other, equally important issues. One is the extent of the Federal government's (and taxpayers') exposure. While closely linked to concerns about adequacy and risk, this issue raises—or should raise—important public policy questions about the purposes and priorities of insurance coverage. And those issues should be considered in proposals for reform because of the strong influence insurance coverage exerts on the allocative functions of the financial system and, thus, on the economy as a whole.

This report's examination of financial guaranty funds in Part III, Chapter 3 points up a number of problems with existing programs and current proposals for deposit insurance reform. The purpose of this Appendix is to outline an alternative proposal intended to focus attention on the wider public policy issues raised in this report. It proposes two major changes in coverage:

Unlimited coverage of non-interest-bearing transactions accounts held in depository institutions; and

Limited coverage of individuals' aggregate holdings of debt obligations issued by regulated financial institutions.

The first prong of the proposal would give priority to insuring the payments system. It suggests that all checkable deposits (currently about $400 billion) should be fully covered whatever their size ($100 or $100 million). The second proposes that coverage for savings should be structured to protect individuals, rather than individual accounts; and that coverage should be extended more uniformly across the financial system to provide more options to savers, to avoid duplications in coverage where possible, to limit the government's exposure and to distribute the allocative effects of insurance coverage more evenly across financial institutions and sectors and their customers.

This proposal borrows some elements from the original and current structure for deposit insurance programs in that it preserves the current prohibition against paying interest on demand deposits to discourage their use as investment assets. However, it recognizes that NOW (negotiable order of withdrawal) accounts have become widely used, and that restrictions on the number of withdrawals have become meaningless—that they are the equivalent of demand deposits. Thus, it includes NOW accounts in the category of transactions balances that should receive full insurance coverage if one or more of the following options is adopted: [1]

Interest is paid only on accounts with average balances of $2,000 or less;

Interest ceilings on such accounts are reimposed; or

Restrictions on the number of periodic withdrawals are reimposed and enforced.

The following analysis offers a comparison of the proposal and current deposit insurance programs in the context of the public policy concerns outlined above.

---

[1] If, as some argue, there is a need to reinstate preferential treatment for thrifts and credit unions in attracting funds to finance housing and encourage lending to small, individual borrowers, the issuance of NOW accounts could be limited to these institutions.

Purposes and priorities of deposit insurance coverage

The original purposes of deposit insurance programs were to protect small savers and prevent economic disruptions to communities. Neither of these purposes is served by current provisions for coverage.

The 1933 legislation establishing the FDIC also imposed interest rate ceilings on savings accounts. Thus, the assumption that savings placed in depository institutions would be those of "small" savers was reasonable; more affluent individuals would tend to invest in higher yielding assets that required a higher level of investment. But now that banks and thrifts can pay market rates of interest, deposit insurance is no longer limited to small savers. Affluent individuals can obtain coverage for an unlimited amount of funds by using brokers to place deposits in individual accounts in different institutions.

The level of coverage is inadequate in the case of transactions balances, particularly those of employers—whether large or small businesses, farmers, nonprofit organizations or state and local governments. If even the smallest institution fails, $100,000 in coverage will not ensure that local payrolls can be met. And the interruption of payments on down the line will result in serious dislocations to communities or even a halt in economic activity. In the case of regional or national institutions that have larger customers and hold clearing balances for other financial institutions, inadequate coverage of transactions balances can result in wider repercussions, causing dislocations to any number of communities, or even the nation as a whole.

The proposal addresses these concerns as follows:

By limiting coverage to individuals rather than accounts, it will not ensure that only small savers are covered, but it will limit coverage to amounts appropriate for small savers;

By giving the highest priority for coverage to the payments system, it will prevent the interruption of those financial transactions essential for maintaining economic activity in all communities and sectors.

Assessing Government exposure and the adequacy of fund reserves

Current methods of measuring the adequacy of deposit insurance funds are themselves inadequate. Neither the funds' aggregate exposure or their exposure in the case of individual institutions is known because exposure (like premiums) is calculated on the basis of total deposits. Since a significant portion of checkable deposits is in excess of $100,000 and only a fraction of large certificates of deposit are covered, the ratio of fund reserves to total deposits clearly overstates exposure.

Nevertheless, concerns about the adequacy of the funds' resources (reserves and existing authority to borrow from the Treasury) are not unrealistic because:

The failure of a single large institution would absorb a sizable share of current resources;

A series of failures would substantially deplete fund resources; and

The absence of full coverage for transactions balances increases the likelihood of a systemic crisis that would strain any fractional reserve system, and trigger a potentially larger government (and taxpayer) exposure involving Federal government loans and loan guarantees.

Because the absence of clarity does not promote confidence, the proposal offered above is structured so that the level of exposure could be more easily verified:

Data on checkable deposits that would be fully covered are already collected as a component of information critical for the conduct of monetary policy.

The addition of procedures for registering individuals' savings would not be burdensome and their holdings could be verified as part of existing procedures that provide information on interest earnings for income tax purposes.

Using existing FDIC reserves to back transactions balances would ensure adequate coverage for the payments system and enhance the credibility of Government backing for demand deposits because:

The ratio of current FDIC reserves ($19 billion) to total checkable deposits ($400 billion) is almost five percent—approximately the ratio of reserves to total deposits at the beginning of the 1970s and considerably higher than the current ratio (1.7 percent)—and

Total checkable deposits amount to about twice the level of Federal Reserve assets but less than half of annual Federal budget outlays.

A new fund would be needed to cover savings and the required level of reserves would have to be determined over time. It would require an initial contribution of reserves from existing funds (the FDIC, the FSLIC and the National Credit Union Share Insurance Fund - NCUSIF) and the Treasury, and authority to borrow from the Treasury. However, by using the current level of assessments, reducing the amount of coverage initially—*e.g.*, to $25,000 for a single individual, $50,000 for a couple and $75,000 for a family with dependents—and widening the base for assessments to include balances held with other regulated financial institutions, a new fund could be established (as was done in 1933) that would distribute both the burdens and benefits of insurance for savings more evenly across the financial system.

The potential for abuse by institutions and depositors

As discussed elsewhere in this report,[2] current deposit insurance programs can be abused by both institutions and depositors. Uniform coverage and costs allow both weak and sound institutions to attract funds on an equal footing. And the payment of market rates of interest on deposits not only encourages a larger flow of funds to depository institutions but allows more affluent depositors to exploit the protections offered by insurance coverage by placing funds with weaker institutions that are willing to pay a higher rate for them. The existing potential for abuse encourages risk-taking and significantly increases the insurance funds' exposure and vulnerability.

The proposal for full coverage of transactions balances and limited coverage for savings accounts minimizes the potential for abuse:

> Prohibiting the payment of interest on checkable accounts would discourage their use as investment assets and thus limit their growth and the insurance fund's aggregate exposure.
>
> The ability of the fund to cover all checking accounts promptly in the event of problems—the failure of a large institution, a series of failures or even a systemic crisis—would facilitate adoption of other proposals to prevent abuse such as risk-related insurance premiums, risk-based capital ratios and increased disclosure.
>
> Limiting coverage for savings to individuals rather than individual accounts would put a stop to such practices as breaking up large deposits into insured lots and curtail the ability of savers to exploit insurance coverage by choosing unsound institutions.

The allocative impact of deposit insurance on savings and credit flows

Institutions that can issue liabilities that are insured or guaranteed by government agencies have significant advantages in attracting funds. Although there are a variety of Federal credit and loan guaranty programs that have extended this advantage to other financial institutions and sectors,[3] depository institutions are the primary beneficiaries of current financial guaranty programs in terms of the scope of coverage and its value in enhancing the attractiveness of their services.

In the past, the benefits of deposit insurance for both institutions and depositors were offset to some degree by interest rate ceilings on deposits and other regulatory costs—*i.e.*, for examinations, insurance premiums and reserve requirements. Although these regulatory costs are still in effect, the removal of interest rate ceilings has greatly increased the attractiveness of large and small deposits as investment assets. This report has repeatedly called attention to the fact that the payment of market rates of interest on *insured* short-term financial assets is a financial innovation without historic precedence—one that has profoundly altered the flow of savings and capital and credit because it undermines the risk/reward incentives that have traditionally encouraged investment in long-term financial assets.

The case for restoring the balance between short- and long-term financial investment has been argued elsewhere in this report.[4] Restoring that balance does not require a return to interest rate ceilings. But it will require reassessing the purposes and priorities of insurance programs in light of the dramatic changes in the institutional environment as well as the profound allocative impact of interest rate deregulation. Proposals that merely tinker with existing programs can only worsen the allocative distortions that have emerged.

Providing full insurance coverage for checkable deposits that do not pay interest (or pay only a limited amount of interest on small accounts with limited withdrawal privileges) will tend to discourage their use as investment assets while enhancing their attractiveness relative to repurchase agreements, money market mutual funds and other short-term cash-management instruments. Extending Federal insurance coverage to debt obligations issued to small, individual savers by other regulated financial institutions—*e.g.*, fixed annuities offered by insurance companies or face amount certificates issued by closed-end mutual funds—would not only offer greater protection and more choices to small savers, but also augment the potential for Individual Retirement Accounts (IRAs) to channel savings into longer-term financial assets. Thus, the proposal will:

---

[2] See Part II, Chapter 1 and Part III, Chapter 3.

[3] See the discussion of Government programs in Part II, Chapter 1 and the discussion of mortgage-backed securities in Part II, Chapter 4.

[4] See Part II, Chapters 1 and 4.

Preserve the ability of depository institutions to intermediate between the short-term preferences of depositors and the longer-term preferences of their traditional borrowers by ensuring access to a relatively stable source of low-cost funds;

Enhance the attractiveness of long-term financial investment and reduce pressures on other financial sectors to compete with banks in offering short-term liabilities; and

By restoring the balance between short- and long-term savings flows, facilitate capital formation, promote economic growth and maintain credit quality.

While this proposal is by no means a perfect vehicle for addressing all concerns about the adequacy of deposit insurance funds and the implications of financial restructuring for this critical component of customer protection, it is intended to suggest that addressing these issues will require a wider focus than has been apparent so far. The amount of restructuring that has already occurred requires a reevaluation of the purposes and priorities for deposit insurance and a careful analysis of how changes in existing programs have—and will—impact on other financial sectors and the economy as a whole.

○